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*Policy paper*

***ASSESSMENT OF THE PROSPECTS OF  
HIGHER EXCISE TAX RATES ON TOBACCO  
PRODUCTS IN MOLDOVA***

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## EXECUTIVE SUMMARY

To ensure stable tax revenues to the state budget, fiscal policy aimed at increasing excise tax rates on tobacco products should take into account economic realities in the country, in particular the growth rate of real incomes of the population and the affordability of tobacco products, the tax burden on different categories of tobacco products, as well as effective mechanisms to control illicit trade in tobacco products.

One of the goals of the excise policy is also to decrease the affordability of tobacco products by raising prices and, as a result, to reduce tobacco consumption. This goal can be achieved if the rise in prices for tobacco products is higher than the rise in real incomes of the population, and if smokers have no alternative ways to cut the cost of consumption, for example by switching towards a more affordable category of tobacco products or illegal products.

In recent years, excise rates in Moldova and, as a result, prices of tobacco products have grown faster than inflation and real incomes of the population. For instance, in 2021, the affordability of cigarettes for a consumer in Moldova is 25% of the average income. For comparison, in advanced countries this indicator is 15%. At the same time, a substitution effect is observed in Moldova, that is the flow of smokers to the low price segment, represented by cigarillos and filtered cigarettes below cost. A significant excise burden on legal producers and consumers creates an economic opportunity for unscrupulous economic agents, which reduces the effectiveness of tax regulation of the tobacco market and distorts market conditions.

As part of the fiscal policy for 2022, the government proposed to increase excise rates on filtered and unfiltered cigarettes by 15%, to introduce a minimum effective rate on cigarillos, which will be equal to the level of cigarettes, and also to introduce an excise duty on electronic cigarettes. For a more comprehensive assessment of this initiative, a SWOT analysis of the increase in excise tax rates on tobacco products in Moldova has been carried out. The study also analyzes the experience of Ukraine in the fiscal policy of tobacco products in the regional context.

Moldova has a balanced structure of excise taxes for filtered and unfiltered cigarettes with a minimum effective rate, which ensures the fulfillment of a significant part of the excise collection target. The proposed increase in the minimum effective rate of excise tax on filtered and unfiltered cigarettes by 15%, which is twice the inflation rate, is in line with the goals of public health.

The proposed introduction of a minimum effective rate of excise tax on cigarillos, which is equal to the level of filtered and unfiltered cigarettes, as well as excise duty on electronic cigarettes, eliminates tax benefits for these products, which is supposed to provide additional revenues to the state budget and eliminate some structural market distortions.

In addition to this, the Moldovan government should pay attention to the risks associated with undervaluation by cigarette manufacturers in order to increase their competitiveness in the tobacco market. To eliminate this structural deformation of the market, it is reasonable to use the mechanism of the minimum retail sale price of cigarettes and cigarillos, at least for a certain transition period. This measure helps collect VAT and profit tax in full, and also meets the goals of public health, since it raises retail sale prices of tobacco products (over the past two years in Moldova, despite the annual increase in excise, prices of products of a low price segment have not changed).

In further increasing excise rates, the Moldovan government should consider such risks as the possibility of substitution of tobacco products with a high level of excise taxation for cheaper alternatives, for example, roll-ups, which may not meet state standards; new forms of sales of illegal products, including e-commerce; illicit traffic in tobacco products caused by different approaches to excise taxation in certain jurisdictions, in particular in the Transnistrian region.

The moderate indicator of the shadow market of tobacco products in Moldova in modern conditions should not inspire the authorities with calm. The experience of the countries of the Balkan region, the Baltic States and Ukraine shows the risks of a sharp increase in illegal products on the market with a disproportionate growth of excise rates in comparison with a rise in household income. When there is such an increase in excise rates, that is, an “excise shock”, consumers often choose illegal products, which are much cheaper. In addition to developing the institutional environment in the field of combating and countering the illegal production and circulation of tobacco products, it is important to eliminate the fundamental reasons for the emergence of this market, which are not only economic.

In the regional context, it is necessary to pay attention to the experience of Ukraine in raising the excise rates on tobacco products. It should be noted that the experience of Ukraine is not the best example to follow for many reasons. One of the main ones is that the tax system of Ukraine per se has serious structural imbalances, which cause such negative phenomena as tax evasion, a large shadow sector of the economy, etc. State tax policy in Ukraine, the essence of which is that “the average and honest payer will pay for everything” cannot be an example to follow and a basis for a long-term stable inclusive economic growth in any country.

## I. GENERAL CHARACTERISTICS OF THE TAX SYSTEM AND EXCISE POLICY OF UKRAINE

**The Ukrainian practice of development and implementation of state tax policy is not the best example to follow, since the tax system of Ukraine per se has significant structural imbalances.** These imbalances lead to undesirable socio-economic consequences, which should be discussed, especially in the case of bringing the experience of Ukraine into the practice of other countries. The study devoted to these features of the Ukrainian tax system is in the public domain, therefore here we should only briefly list some of the conclusions from it.

Firstly, the tax system of Ukraine is characterized by a disproportionate distribution of the tax burden both by tax types, tax bases, and by level of income. This considerably distorts the incentives of economic agents, leads to unfair competition, which ultimately, in practice, is manifested itself in a significant shadow sector of the economy, creating conditions for opportunistic behavior of taxpayers.

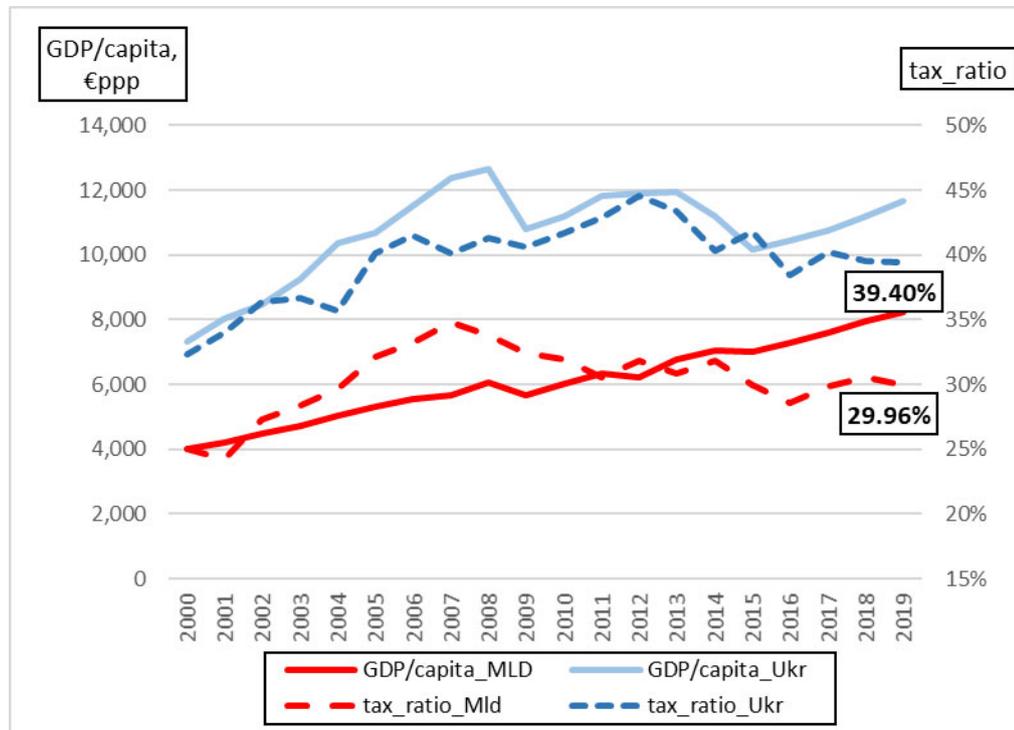
Secondly, over a long period of time, there has been a steady increase in indirect taxes (VAT and excise) on imported goods and services, which, at the same time, is both a cause and a consequence of the de-industrialization of the Ukrainian economy.

Thirdly, this is not mentioned in the above study, but should be noted in the context of a possible introduction of the experience of Ukraine into the practice of other countries, lack of institutional effectiveness of regulatory authorities (corruption, complexity and closedness of administration procedures, technical backwardness, lack of competence and motivation of personnel, etc.) including tax offices can lead to undesirable socio-economic consequences. This may fully concern even progressive tax initiatives, the implementation of which has given positive results in other countries.

**Both practice and theory show that two key points of the tax system are important for stable inclusive economic growth, namely, how taxes influence the economic efficiency (tax efficiency) and how the tax burden is distributed among economic agents (tax incidence).**

Even a cursory glance at the dynamics of key socio-economic indicators tells us that, in fact, Moldova has succeeded more than Ukraine in increasing the welfare of its citizens over the past 20 years, despite the fact that the GDP per capita in Ukraine in absolute terms is higher. The gap in this indicator, calculated at purchasing power parity in euros in constant 2021 prices, narrowed by more than

15% from 2000 to 2019, which became possible due to the fact that the average growth rate of this indicator for the given period in Moldova was 3.6% versus 2.3% in Ukraine (see Fig. 1).



**Figure 1. GDP per capita Ukraine vs Moldova, tax ratio Ukraine vs Moldova**

*Source:* compiled by the authors based on data from <https://wid.world/> and <https://www.wider.unu.edu/>

At the same time, the total value of the tax burden, measured by the tax ratio, as can be seen from the above graph, is almost 10 percentage points in relation to GDP higher in Ukraine than in Moldova. As of the end of 2019, the absolute value of the tax ratio in Moldova was 29.96% of GDP, and in Ukraine it was 39.4% of GDP.

**In this regard, any increase in the tax burden should be considered in the context of how it is justified to the detriment of economic growth.**

The tax systems of Moldova and Ukraine have, in general, rather similar basic characteristics, but at the same time, some quantitative structural parameters are quite different, which essentially can also greatly affect the rate of economic growth. There is a fairly large amount of academic literature on this subject that examines the effect of tax structure on growth.

The data on the decomposition of the tax ratios of Ukraine and Moldova by their main components are as follows: direct (personal income tax, corporate income tax), indirect taxes (VAT, excise duty), social security contributions, and other taxes and taxation bases (labor, capital and consumption).

Table 1

**Decomposition of the tax ratio of Ukraine, 2019**

<b>Tax Ratio Ukraine=39,4%</b>					
<b>IT=12,98%</b>		<b>DT=9,88%</b>		<b>SSC=7%</b>	<b>OT=9,54%</b>
<i>VAT=9,53%</i>	<i>Ex=3,45%</i>	<i>CIT=2,95%</i>	<i>PIT=6,93%</i>		
<b>Consumption</b>		<b>Capital</b>		<b>Labor</b>	

Table 2

**Decomposition of the tax ratio of Moldova, 2019**

<b>Tax Ratio Moldova=29,96%</b>					
<b>IT=12,57%</b>		<b>DT=4,44%</b>		<b>SSC=8,76%</b>	<b>OT=4,13%</b>
<i>VAT=9,61%</i>	<i>Ex=2,96%</i>	<i>CIT=2,55%</i>	<i>PIT=1,89%</i>		
<b>Consumption</b>		<b>Capital</b>		<b>Labor</b>	

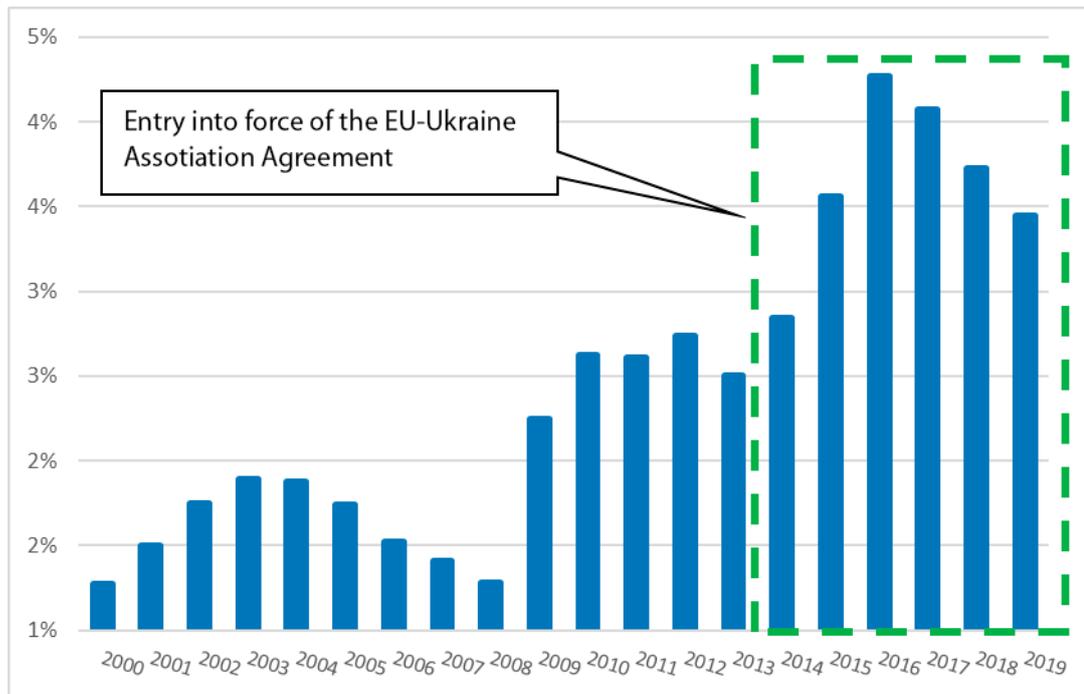
Source: compiled by the authors based on data from <https://www.wider.unu.edu/>

As can be seen from the above data, there are significant differences between the quantitative parameters of tax systems for excise tax, personal income tax and social security contributions. It should be mentioned that with almost the same level of capital taxation, individuals in Ukraine pay more than three times higher personal income tax (6.93% of GDP) than in Moldova (1.89% of GDP). This is related both to the difference in rates (18% in Ukraine vs 12% in Moldova), and to some difference in approaches to determining the tax base. If we take into account that indirect taxes (VAT and excise) are taxes on consumption, the tax burden of which is also borne by individuals, then we can calculate that as a percentage of GDP Ukrainian consumers pay by 5 percentage points more taxes in Ukraine (19.91% of GDP) than in Moldova (14.46%). This definitely reduces the rate of economic growth in Ukraine. This can be seen from comparative historical data.

**A significant contribution to the increase in this burden in Ukraine was made by the policy of expanding the base of excise tax and raising its rates, including the fact that the policy is also related to the undertaken obligations to implement European taxation standards** (see Fig. 2). This graph shows that the total tax burden that arises from excise taxes has significantly risen since 2014. At the same time, as can be clearly seen in Fig. 1, the average income level in Ukraine, the proxy indicator of which is the GDP per capita, has declined for this period.

**The implementation of European practices and standards of taxation without taking into account the features and socio-economic realities of the country (income level of the population, behavioural patterns, institutional features, etc.) has proved to result in losses for the economy and the state**

**budget.** For example, according to the KANTAR<sup>1</sup> study, the level of the shadow cigarette market in Ukraine has reached a historical maximum and, as of August 2021, accounts for 18.1% of the volume of the legal market, and the losses of the state budget, the so-called tax gap on excise tax on tobacco products, are estimated at UAH 14.4 billion, or about EUR 480 million at current exchange rates.



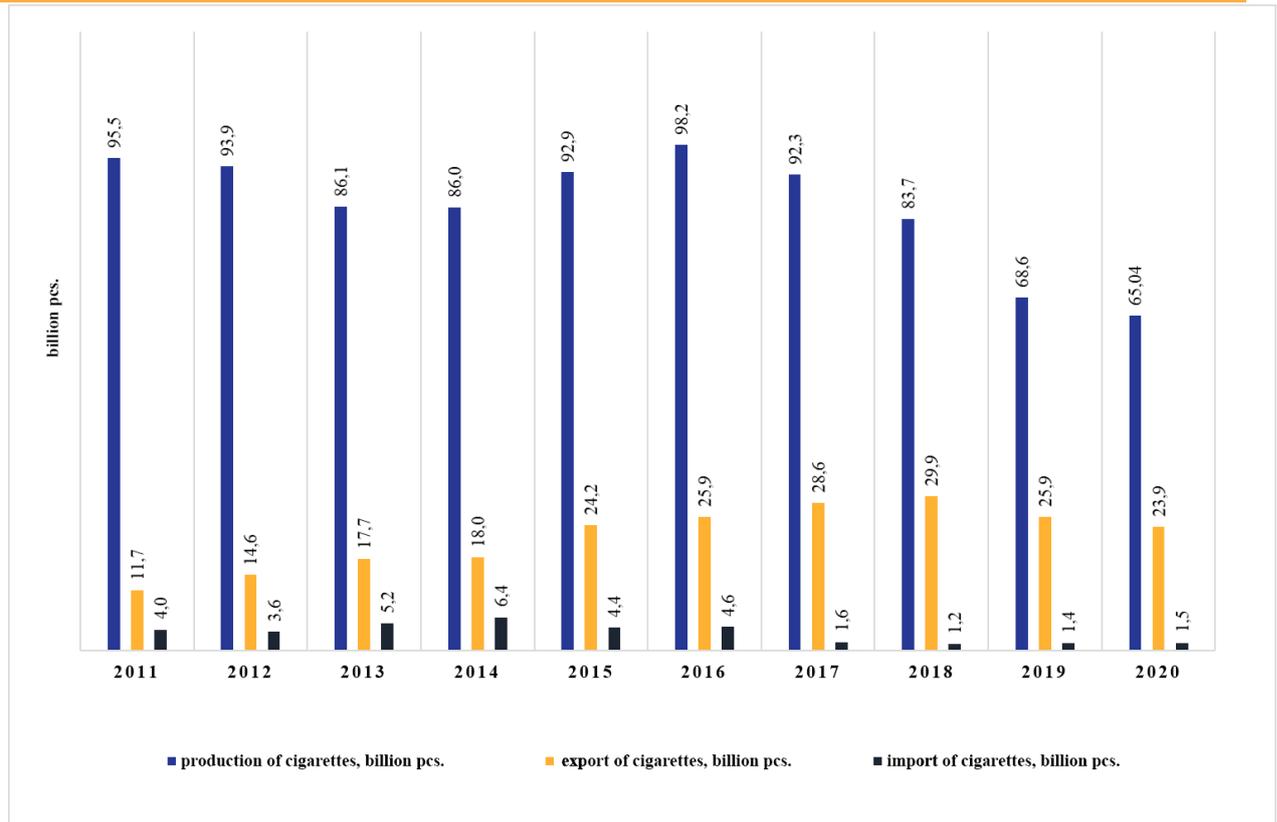
**Figure 2. Dynamics of excise tax increase in Ukraine, as a % of GDP.**

Source: compiled by the authors based on the data of the Ministry of Finance of Ukraine

Analysts note that with a more moderate rate of increase in tax rates, the tobacco market in Ukraine could be much larger, and this is additional investments, jobs and, ultimately, additional tax revenues. In Ukraine, the tobacco industry provides 7% of all tax revenues of the state budget, and international tobacco companies are constantly ranked among the largest and most conscientious taxpayers of Ukraine. Therefore, the state tax policy, which is based on increasing the tax burden on average and conscientious taxpayers dramatically, in general cannot be considered prudent and reasonable, since further movement in this direction entails higher level of opportunistic behaviour of taxpayers, a growing shadow sector of the Ukrainian economy and other negative phenomena.

The dynamics of the development of the tobacco market in Ukraine is shown in Figure 3.

<sup>1</sup> Kantar Ukraine is a representative of the world leader in marketing research company Kantar, which, in particular, conducts interviews, receiving packs, examining packs, identifying illegal packs of cigarettes in a sample of 3000 smokers aged over 18.5 years old.



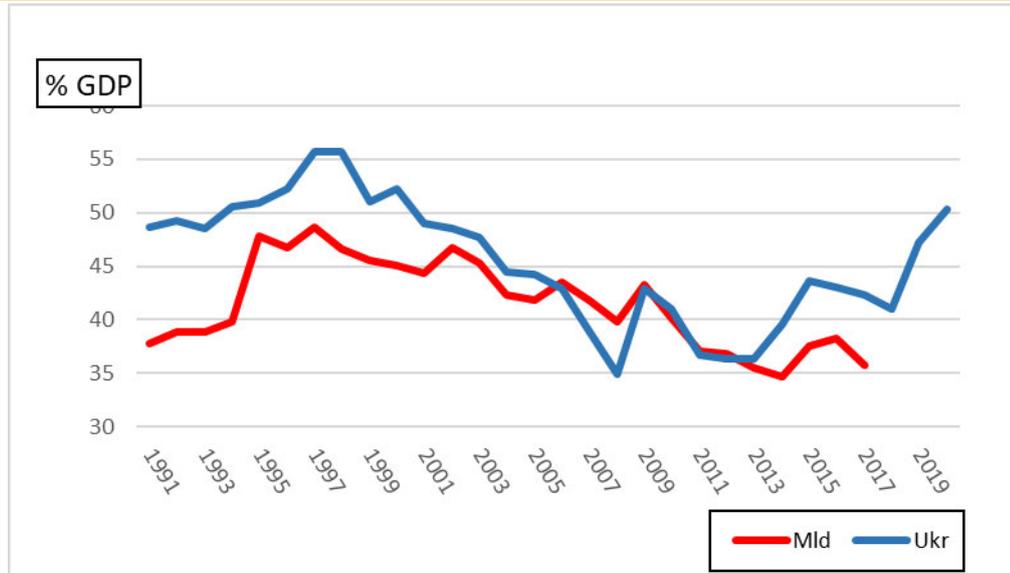
**Figure 3. The missed opportunities of the tobacco market in Ukraine, the production of cigarettes, billion pcs. 2011 – 2020.**

*Source:* calculated according to the State Statistics Service of Ukraine, State Tax Service of Ukraine (reports 3-RS), State Treasury of Ukraine

As we can see, there is a negative trend in the volume of manufactured products.

**Ukraine can hardly be an example for Moldova in terms of the de-shadowing of the economy.** This is proved by the facts. For example, when considering the long-term dynamics of changes in the shadow sectors of the economies of our countries (see Fig. 4), one can clearly see that Moldova has been more successful in the fight against the shadow economy. In Ukraine, quite the opposite, international experts note the growth of this sector in recent years. According to updated estimates by Leandro Medina, Friedrich Schneider, as of 2020, the size of the shadow economy is more than 50% of GDP.<sup>2</sup>

<sup>2</sup> It should be noted that the Ministry of Economy of Ukraine (formerly the Ministry of Economic Development and Trade) systematically provides more modest estimates of the shadow segment of the Ukrainian economy on average at the level of 30-33% of GDP. In this case, we tend to trust the assessments of German experts, given the advantages of the methodology for their assessment and the absence of conflicts of interest.



**Figure 4. Dynamics of the shadow sector of the economy in Ukraine and Moldova, 1991 - 2020<sup>3</sup>**

Source: compiled by the authors based on [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3502028](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3502028)

**We should note that the shadow segment of the market can exist and grow even against the will of the national governments of Ukraine and Moldova,** since on their eastern borders both states have sufficiently large areas of uncontrolled territory that can be as either a transit or a place for the production of counterfeit and/or contraband goods.

**The study of the Kyiv School of Economics, on the basis of which the PAS center developed an initiative to increase excise tax rates on tobacco products in Moldova according to the Ukrainian scenario, in our opinion, does not provide sufficient arguments in favor of such initiative except a comparative analysis of rates and prices for tobacco products in our countries.** In any case, it does not take into account the current socio-economic situation in our countries, the characteristics of the structure of the economy, internal and foreign policy factors. Furthermore, another study of the Kyiv School of Economics mentions that “Smoking was found to decrease food and beverage expenditures along with healthcare expenses. Concerning increasing excise tax on cigarettes, low-income households are expected to suffer more from crowding out expenses on necessities.” In other words, this means that rising price of cigarettes, without a structured and comprehensive approach to the fight against smoking, *ceteris paribus* leads to a decline in the well-being of the population.

<sup>3</sup> Data for Moldova in this study are for 1991-2017, for Ukraine data are for 1991-2020

## II. SWOT-ANALYSIS OF HIGHER EXCISE TAX RATES ON TOBACCO PRODUCTS IN MOLDOVA

In order to make a comprehensive assessment of the initiative to increase excise tax rates on tobacco products in Moldova, proposed by the government, we carried out a SWOT analysis. The SWOT matrix is as follows.

### Raising excise tax rates on tobacco products in Moldova – government proposals

<b>Strengths</b>	<b>Weakness</b>
<ul style="list-style-type: none"> <li>• Increased excise tax on filtered and unfiltered cigarettes by 15%, twice the inflation rate</li> <li>• Introduction of excise tax on electronic cigarettes</li> <li>• Introduction of the minimum effective rate (MER) of excise tax on cigarillos, at the level of cigarettes</li> <li>• MER guarantees minimum income to the budget and fulfillment of a significant part of collecting excise</li> <li>• Annual indexation of MER to the inflation rate and higher corresponds to the goals of public health</li> </ul>	<ul style="list-style-type: none"> <li>• The growth rate of excise tax rates is much higher than the growth rates of population incomes, which causes the substitution effect on the market – the transition of smokers to the low price segment</li> <li>• Despite the annual increase in excise tax, prices for low price segment products do not change, which does not correspond to the goals of public health</li> <li>• Absence of a minimum retail price for cigarettes and cigarillos is VAT and income tax loss</li> </ul>
<b>Opportunities</b>	<b>Threats</b>
<ul style="list-style-type: none"> <li>• Introduction of a minimum retail price for cigarettes and cigarillos</li> <li>• Reducing the possibility of illegal movement of tobacco and nicotine-containing products in border countries</li> <li>• Increased state control over turnover of illegal products on the territory of the state</li> </ul>	<ul style="list-style-type: none"> <li>• Replacement of demand for cigarettes with roll-ups, possibly substandard roll-ups</li> <li>• Further distribution of products below cost on the market</li> <li>• Increase in the share of the low price segment, which does not correspond to the goals of public health and facilitates the illegal movement of cigarettes to neighbouring countries</li> </ul>

## Strengths

### **Increased excise tax on filtered and unfiltered cigarettes by 15%, higher than the inflation rate**

In Moldova, there has been a gradual rise in revenues from excise taxes on tobacco products over the past years, which corresponded to the paradigm of a balanced state tax policy in accordance with the current annual plan to increase the excise tax by 15%. The average growth rate of excise revenues from these products in 2018–2020 was 6%. At the same time, the average consumer inflation for 2018–2020 was 3.9%. Thus, revenues from excise taxes exceeded inflation by more than 2 percentage points, or by a factor of 1.5.

Moldova has a balanced structure of excise taxes for filtered and unfiltered cigarettes with a minimum effective rate, which ensures the fulfillment of a significant part of the excise collection target. A gradual and reasonable increase in the minimum effective rate is an efficient mechanism for reducing tobacco consumption, which is evidenced by empirical studies by F. J. Chaloupka, A. B. Laffer, the Growford Institute.

The proposed increase in the minimum effective rate of excise duty on filtered and unfiltered cigarettes by 15%, twice the inflation rate, meets the goals of public health, and is also economically justified as this approach is supposed to ensure the stability of excise revenues to the state budget and prevent the illegal market from growing.

### **The introduction of the minimum effective rate of excise tax on cigarillos at the level of cigarettes eliminates the tax exemption for this category and helps eliminate the structural distortion in the market**

Taking into account economic realities, in Moldova, there was quite often a situation when consumers moved to more accessible segments, which appeared because of imbalances in taxation. For example, before rates on filtered and unfiltered cigarettes were established at the same level in 2020, the increase in excise taxes and prices of filtered cigarettes had provoked a drop in their sales and thereby a growth of the segment of unfiltered cigarettes (if in 2014 the share of unfiltered cigarettes (import and production) was 21 %, then in 2016 it was almost 30%). In 2019, the increase in the excise tax on unfiltered cigarettes and their rise in price led some smokers to reorient to finely chopped tobacco for rolling, the price of which was lower than the price of unfiltered cigarettes. For a long time, the excise rates on these products were low, MDL 147 per 1 kg (it is about MDL 160–170 per 1,000 cigarettes), while the excise tax on cigarettes averaged MDL 400–500. The segment of roll-ups disappeared in the second half of 2019, after the corresponding excise rate was raised almost 7 times, as a result of which the price of a package of finely chopped tobacco weighing 30 g increased from MDL 19 to 54, (that is in 1.5 times) one and a half times more expensive than filtered cigarettes. In 2020, after rates on filtered and unfiltered cigarettes had been equalized, the unfiltered cigarette segment decreased from 21% in 2019 to 9% in 2020 and practically disappeared in 2021. At the same time, due to the abolishment of the minimum retail sale price, a

segment of cheap filtered cigarettes and cigarillos began to grow, which now have reached a market share of 16% and 11%, respectively.

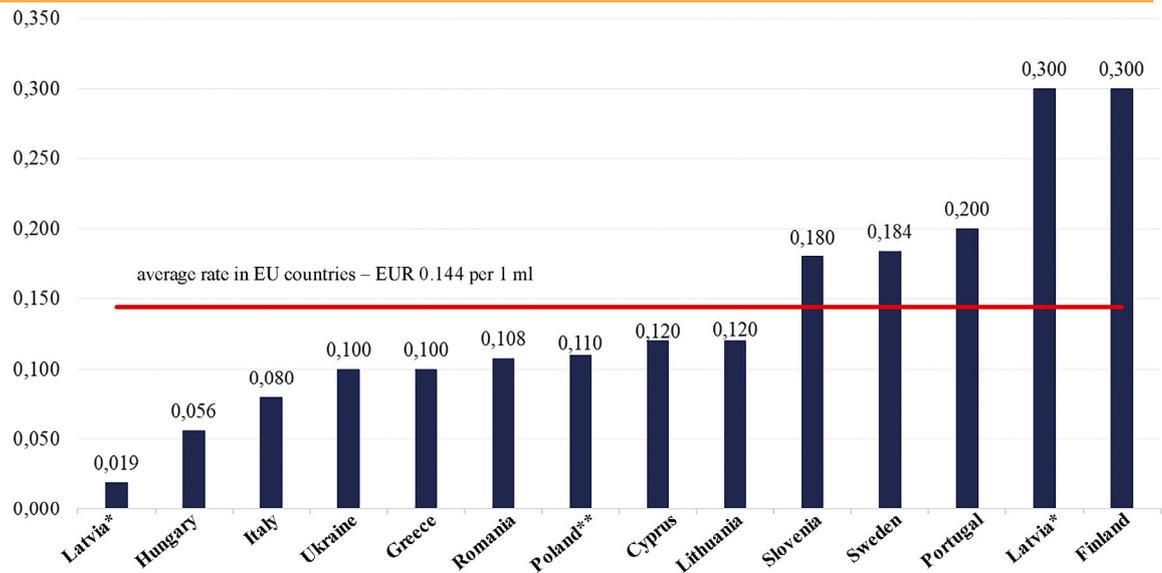
To date, cigarillos are taxed at a rate of 41%, therefore they have a significant tax advantage: the minimum effective rate on cigarettes is MDL 17 per pack, while for cigarillos, taking into account the average price of MDL 15, the excise tax is only MDL 7. Moreover, the tax rate on cigarillos has not been changed, which allowed market operators not to raise the price of cigarillos in 2021. As a result, for filtered cigarettes at cost price, the sum of excise tax and VAT is MDL and for cigarillos, it is only MDL 10.

The government's proposal to introduce the minimum effective rate on cigarillos from 2022 is supposed to provide additional revenues to the state budget through increasing the excise component and VAT, since the introduction of the minimum effective rate is supposed to cause an increase in retail prices for this category, which is also in line with the goals of public health.

### **Taxation of e-liquids will boost budget revenues and prevent structural deformations in the market**

State fiscal measures should include not only an increase in tax rates on existing excisable goods, but also expand the tax base, including new types of products. **It is advisable to tax liquids that are used for e-cigarettes.** Lack of public regulation in general and taxation of e-cigarettes can lead to a shift in demand from taxable products to non-taxable ones and to the corresponding reduction in excise tax revenues. According to Euromonitor International, currently there are about 40 million consumers of this product in the world, which is 3.6% of the number of smokers, in Ukraine this share is 7%.

The excise tax on e-liquids already exists in 14 EU countries: Greece, Estonia, Italy, Cyprus, the Netherlands, Latvia, Lithuania, Portugal, Poland, Romania, Slovenia, Hungary, Finland, Croatia and Sweden (Fig. 5). The average rate is EUR 0.144 per milliliter. Taxation approaches in EU countries differ, both nicotine-containing e-liquid and zero-nicotine products are taxed. For example, Latvia imposes an additional tax (EUR 0.005 per milligram) on the weight of the nicotine used, while Italy applies a specific rate depending on whether the liquid contains nicotine or not, and is calculated based on the weighted average price of traditional cigarettes. In Croatia, e-cigarettes are classified as excisable goods, but a zero rate is set. In Ukraine, since 2021 this tax has also been introduced with a specific rate of EUR 100 per 1 liter of liquid.



\* the rate in Latvia is indicated taking into account the additional excise taxation of nicotine at a rate of EUR 0.005 per ml; it is taken from the calculation of the nicotine content of 18 mg in a container with a liquid volume of 10 ml.

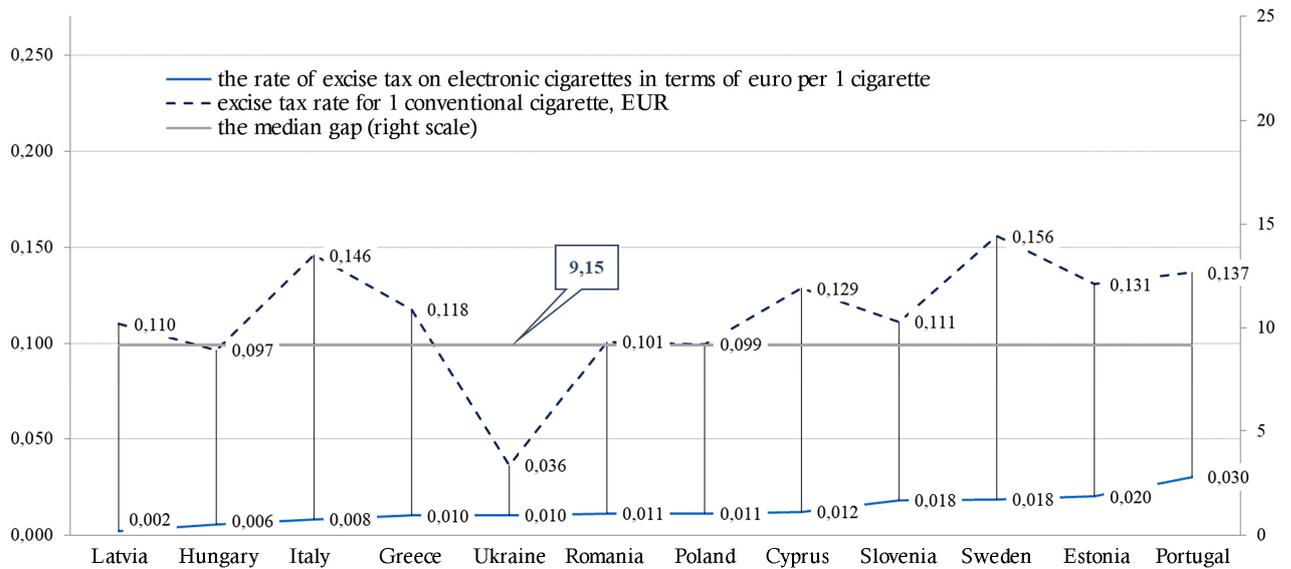
\*\* From July 1, 2020

*Note:* Rates are set in national currency and converted at the April 2020 euro exchange rate, according to Eurostat.

**Figure 5. Rates of excise tax on liquids for electronic cigarettes in the EU and Ukraine in 2021, EUR per ml**

*Source:* compiled by the authors based on: Tax Data Center. Vapor Products Tax. URL: <https://vaporproductstax.com/taxation-database/>; Tax Regulation of the Tobacco Products Market In the Conditions of Its Transformation [V. I. Korotun, T. V. Koshchuk, N. V. Novytska, I. I. Khliebnikova,] / Ed. by T. V. Koshchuk. Irpin – Khmelnytskyi, 2020. 121 p. URL: <https://www.ndifp.com/1537/>

The median gap between excise rates on traditional and electronic cigarettes in the EU countries in 2020 is no more than 9 times and ranges from 57.9 times in Latvia to 4.56 times in Portugal. In Ukraine, in 2021, this gap is 3.38 times, and in 2025 after a series of increases in the excise tax rate for traditional cigarettes it will be 7.35 times (Fig. 6).



*Notes:* in terms of one conventional cigarette by ratio of 1 ml of liquid = 10 conventional cigarettes; excise rates on such liquids in the EU countries are taken as of May 2020; in Latvia, the liquid rate is indicated taking into account the additional excise taxation of nicotine at a rate of EUR 0.005 per ml, based on the nicotine content of 18 mg in a container with a liquid volume of 10 ml.

**Figure 6. The ratio between the rates of excise tax on liquids for electronic cigarettes and on traditional cigarettes in the EU countries and Ukraine, in terms of one conventional cigarette**

*Source:* author’s calculations based on: Tax Data Center. *Vapor Products Tax*. URL: <https://vaporproductstax.com/taxation-database/>; Excise Duty Tables. Part III – Manufactured Tobacco. European Commission. URL: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/taxation/excise\\_duties/tobacco\\_products/rates/excise\\_duties-part\\_iii\\_tobacco\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties-part_iii_tobacco_en.pdf) ; Tax Regulation of the Tobacco Products Market In the Conditions of Its Transformation [V. I. Korotun, T. V. Koshchuk, N. V. Novytska, I. I. Khliebnikova,] / Ed. by T. V. Koshchuk. Irpin – Khmelnyskyi, 2020. 121 p. URL: <https://www.ndifp.com/1537/>

The development of the electronic cigarette market in Moldova in recent years highlights this issue, otherwise conditions for a further distortion of the market are created. Moldova is the only country in Central and Eastern Europe that has not introduced an excise tax on e-liquids. If an excise tax is not introduced in Moldova, there is an increased likelihood of smuggling liquids to neighboring countries, primarily Romania and Ukraine. According to the State Tax Service of Ukraine, there is already a significant amount of illegal vaping liquids in Ukraine. The lack of effective mechanisms to control the turnover of these products leads to the fact that illegal goods cross the customs territory of Ukraine in international mail and carry-on baggage concealed from customs control. Then, these liquids are sold through online stores and retail for cash without reflecting these transactions in bookkeeping and tax accounting. As a result, this leads to less budget revenues from the excise tax to the budget of Ukraine.

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## **Opportunities**

**The introduction of a minimum retail price for cigarettes and cigarillos could help to increase fiscal revenue from VAT and profit tax, as well as to ensure an annual increase in the price of cigarettes and cigarillos in line with the goals of public health.**

In Moldova, due to the low purchasing power of the population, there is a substitution effect on the tobacco market – a transition to products of a low price segment, which in 2021 reached 30% of the market share. A similar trend is typical for other European countries. According to Eurobarometer studies, consumers of these tobacco products are from socially vulnerable groups with fewer employment opportunities, often experience financial distress and are vulnerable to price movements.

The low price segment in Moldova is represented by cigarillos, which were mentioned above, and filtered cigarettes at an average price of MDL 23 per pack. If we add up the excise tax, VAT, and the production and sales costs, the cost of filtered cigarettes pack is MDL 26. Besides, despite the increase in excise taxes, the price of the cheapest offer on the market has not changed compared to 2020 and is MDL 12, although the minimum excise tax per pack is MDL 17.

### **Rationale for the application of the minimum retail price for cigarettes and cigarillos in Moldova**

The excise duty on tobacco products is a consumption tax and is used as an effective tool for generating budget revenues. In most world countries, tobacco excise duties are indexed annually. By raising excise rates, the state, first of all, expects an increase in tax revenues in the same proportionate change of increase in excise rates. In addition, a rise in excise rates on tobacco products is a tool for reducing the affordability of these products. However, an increase in this tax rate may provoke price wars between tobacco companies to gain market share. This, on the one hand, artificially restrains the growth of prices for tobacco products, which in turn leads to a budget shortfall of the ad valorem component of excise tax, VAT and profit tax, and on the other hand, does not reduce the affordability of these excisable goods, which is another barrier to the achievement of health care goals. This problem is typical for both the EU countries and Moldova.

In 2017, the Republic of Moldova introduced the minimum retail price (MRP) for cigarettes. In many countries, it is the mechanism of MRP that is used to increase budget revenues and reduce the affordability of tobacco products. Another

effect of the MRP is transparency and a level playing field for manufacturers in the price issue to reduce the share of unfair competition in the tobacco market.

Let us pay attention to the fact that if in 2016 in Moldova the revenues from excise tax on cigarettes amounted to MDL 1.73 billion, then in 2018 they exceeded MDL 2.5 billion.<sup>4</sup> This significant increase in excise revenues also took place due to the introduction of minimum retail prices for cigarettes in 2017 at the level of MDL 16 per pack of filtered cigarettes and MDL 7 per pack of unfiltered cigarettes (with a further annual increase). In 2019, the minimum retail price for filtered cigarettes was established at MDL 25 per pack, and MDL 19 for unfiltered cigarettes. The need to introduce the MRP in Moldova was due to the appearance on the market of cigarettes of questionable quality at a low price (below cost) of MDL 7-9 per pack, while only the minimum excise tax was MDL 8 per pack.<sup>5</sup>

However, already in the adopted budget of Moldova for 2020, there was no concept of “minimum retail price” for one pack of filtered and unfiltered cigarettes. Minister of Finance S. Pushkutsa announced that the government of the country had abandoned the practice of establishing the MRP for cigarettes in order not to interfere in economic competition. “We believe that it is incorrect for the state to interfere in economic competitive relations by setting some prices. This should be the result of competition, methods of activities, design, promotion and other marketing measures applied by each economic agent,” said the head of the Ministry of Finance. According to him, in any case, the MRP of cigarettes, which the state could insist on, is the sum of excise duty provided by law and calculated VAT.

“Excise duty and VAT from manufacturers and importers are calculated not from the set minimum price, but from the actually formed price for the delivery of products. Therefore, it is incorrect to say that the minimum selling price for cigarettes affects the revenues to the budget. Excise duties on cigarettes in 2020 will increase, according to decisions taken 3 years ago. Next year, the minimum price representing a risk zone for the appearance of tax-free cigarettes on the market will be about MDL 17, that is, it is excise duty plus VAT. And all regulatory authorities, regardless of whether or not there is a set minimum price for cigarettes, will check compliance with the tax regime in terms of the application of excise duty and VAT,” emphasized the head of the Ministry of Finance.

In his opinion, regardless of whether there is a set MRP or not, dishonest economic agents and individuals wishing to trade illegally sell cigarettes without taking into account the minimum price, regardless of what is written in the law.

<sup>4</sup> Cheban L. Rates Rise: Life or Excise Taxes? 16 January 2019. URL: <https://noi.md/ru/mysli-vsluh/stavki-povyshayutsya-zhizni-ili-akcizy>.

<sup>5</sup> Tobacco "Surprise" in 2020 Budget Bill? 02.12.2019 InfoMarket agency comment URL: [http://infomarket.md/ru/marketpuls/tabachnyiy\\_syrpriz\\_v\\_zakonoproekte\\_o\\_byudjete\\_2020\\_goda](http://infomarket.md/ru/marketpuls/tabachnyiy_syrpriz_v_zakonoproekte_o_byudjete_2020_goda).

Commenting on S. Pushkutsa's position, Vice-Speaker of Moldova A. Slusari reminded that the ad valorem part of the excise tax on cigarettes is charged as a percentage of the value of cigarettes. "The minimum sale price for cigarettes set in the budget was very important in terms of budget revenues, the fight against smuggling, and the promotion of a healthy lifestyle. But in the 2020 budget, the minimum sale prices for cigarettes have disappeared," said the vice speaker.

A. Slusari did not agree with S. Pushkutsa's the arguments and noted that when there was a MRP, it was more difficult to deal with such things. "If there is no minimum sale price, we can expect cheap cigarettes on the market for MDL 7-8-10, where the ad valorem component of the excise duty will be calculated based on this price, and the life of smugglers and people using different schemes will be easier. This will stimulate a return to shadow cigarette smuggling schemes."<sup>6</sup>

It was also emphasized that the cancellation of the MRP in Moldova may have a number of negative consequences: the budget will not receive a significant share of excise and VAT revenues (MDL 250–350 million). In other words, there will be a shortfall in millions of lei for each leu of price reduction from MRP which was MDL 19 per pack; a volume of counterfeit products sold in Moldova will increase and a sale of cigarettes at a price below the tax burden will resume; some market participants will want to increase their share by dumping certain positions, unfair competition will intensify; cheap cigarettes will appear again in Moldova, making them more attractive for the consumer, including young people. This will contribute to increases in tobacco use among young people.<sup>7</sup>

It is to be noted that at the beginning of 2021, the cheap segment occupied 20% of the Moldovan tobacco market and it continues to grow. At the same time, a previously unpopular product, cigarillos, has formed a separate niche. Their sales rate is increasing by 5% per month, and as of April 2021, cigarillos had 5.5% of the market. This is an unprecedented case considering that in August 2020 they accounted for no more than 0.3–0.4% of total sales.

The rapid growth of the cigarillos market is due to the fact that these products received tax benefits: the excise tax remained at the level of 2020, 41% of the price. In fact, it turned out to be 8 times lower than the excise tax on conventional cigarettes, which predetermined the commercial success of cigarillos.

As we know, cigarillos are a type of thin cigars in the form of a roll of tobacco leaf stuffed with shredded tobacco. However, in Moldova, due to lack of

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<sup>6</sup> The minimum prices for tobacco products will no longer be set in Moldova. 09.12.2019. <https://mybusiness.md/ru/novosti-biznesa/item/12691-v-moldove-bolshe-ne-budut-ustanavlivat-minimalnye-tseny-na-tabachnye-izdeliya>

<sup>7</sup> Tobacco "Surprise" in 2020 Budget Bill? 02.12.2019 InfoMarket agency comment URL: [http://infomarket.md/ru/marketpuls/tabachnyiy\\_syurpriz\\_v\\_zakonoproekte\\_o\\_byudjete\\_2020\\_goda](http://infomarket.md/ru/marketpuls/tabachnyiy_syurpriz_v_zakonoproekte_o_byudjete_2020_goda).

precision in the sectoral law, the place of cigarillos was taken by a certain hybrid, in which the tobacco leaf was replaced with brown paper. Moldovan cigarillos, both in shape and composition, are very similar to classic cigarettes. But they are cheaper because of low costs.

According to experts, this negative trend is largely due to the very cancellation of the MRP for cigarettes, which was an important indicator of the identification of “shadow” schemes. As a result, in 2021, there appeared cigarillos for MDL 19 on the market. This is a “social” price, considering that a pack of filtered cigarettes in Moldova today costs about MDL35.

There were concerns that cigarillos could occupy up to 8% of sales on the Moldovan tobacco market and this is a good piece of the “cake”, given that the turnover of this market exceeds MDL 3.5 billion per year.<sup>8</sup>

It is important to analyze international experience in addressing this problem. Some EU countries, as is known, use anti-dumping mechanisms to stabilize tax revenues from the sale of tobacco products. After the global crisis of 2008-2009, EU countries experienced an acute shortage of fiscal resources, which prompted them to raise excise rates. These national reforms created the preconditions for revising EU harmonized standards on excise rates for tobacco products. After Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco (codification) had entered into force in 2012, the scope of application of the specific component of the excise duty on cigarettes was expanded, which provides not only stable budget revenues, not depending on the price level, but the same level of burden on cheap and expensive cigarettes, which contributes to the reduction of smoking. If until 2012 the specific component of the excise duty was not less than 5% and not more than 55% of the amount of the total tax burden (resulting from the aggregation of VAT, the ad valorem and specific excise duties), then from 2014 these EU “framework” standards are 7.5 and 76.5 %, respectively. In addition, the Directive provides for an increase in the minimum level of excise duty on tobacco products. In particular, in 2014, the minimum excise duty for cigarettes in the EU rose from EUR 64 to EUR 90 per 1,000 cigarettes. This led to a further increase in excise rates in countries that did not reach the updated standards.

In the context of the post-crisis increased fiscal role of the excise taxation of cigarettes in a number of EU countries, including Italy, Germany and France, there appeared problems with the collection of the planned volumes of excise taxes due to the undervaluation by certain tobacco companies. The presence of cheap cigarettes

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<sup>8</sup> Why have cigarillos increased their turnover? No. 14 (1372). 16 Apr. 2021. URL: [http://logos.press.md/1372\\_12\\_1/](http://logos.press.md/1372_12_1/)

on the market, despite the increase in the excise burden on them, did not contribute to a decrease in the popularity of smoking. At the same time, the decline in the number of smokers who were prompted to quit after a price rise led to less tax revenues from tobacco products. In Germany, price wars were also caused by the transition of some smokers to the consumption of cheaper alternatives (primarily, fine-cut tobacco for the rolling of cigarettes, which remained much cheaper due to relatively low excise rates). A reform was carried out, which provided for in 2010–2015 a gradual increase in the specific (from EUR 82.7 to EUR 98.2 per 1000 pieces) and a decrease in ad valorem (from 24.66 to 21.69%) excise duties for cigarettes, as well as an increase in the specific (from EUR 34.06 to EUR 48.49 per 1,000 cigarettes) and a decrease in ad valorem (from 18.57 to 14.76%) excise duties on fine-cut tobacco for the rolling of cigarettes<sup>9</sup>. Before the gap between the excise burden on these categories of excisable goods was narrowed, the issue of using the anti-dumping mechanism to protect the revenues of excise tax and VAT on cigarettes from reduction had been especially acute.

Since April 2010, Germany has been calculating its excise duty (specific and ad valorem components) and VAT on the weighted average retail selling price of cigarettes, which serves as a basis for comparison with the corresponding figures for a specific maximum retail price. If the aggregate specific, ad valorem and VAT excise taxes are below the specified minimum threshold, the difference is payable as an additional excise duty. In addition, until February 2016, Germany also established a fixed minimum aggregate tax per unit of the product. If it was higher than the same indicator for the weighted average retail price, then the additional excise tax was calculated based on this fixed amount<sup>10</sup>. This double regulation kept cigarette tax revenues from being reduced even under significant price volatility.

Fiscal mechanism to counter dumping in the cigarette market used by Germany in 2011–2017 allowed accumulating excise tax revenues at the level of more than EUR 12 billion per year<sup>11</sup>, despite the reduced use of tobacco products

<sup>9</sup> Excise Duty Tables. Part III – Manufactured Tobacco / European Commission. 2010. URL: [http://www.adko.hu/01\\_files/adattar/tobacco\\_en.pdf](http://www.adko.hu/01_files/adattar/tobacco_en.pdf); Excise Duty Tables. Part III – Manufactured Tobacco / European Commission. 2012. URL: [https://circabc.europa.eu/sd/a/f0f5445c-c154-4524-905f-0f8c15984494/Excise\\_Duty\\_Tables%20-%20III-Tobacco\\_July2012\\_REV1.pdf](https://circabc.europa.eu/sd/a/f0f5445c-c154-4524-905f-0f8c15984494/Excise_Duty_Tables%20-%20III-Tobacco_July2012_REV1.pdf); Excise Duty Tables. Part III – Manufactured Tobacco / European Commission. 2016. URL: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/docs/body/excise\\_duties-part\\_iii\\_tobacco\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/excise_duties-part_iii_tobacco_en.pdf).

<sup>10</sup> Tobacco Tax Act (TabStG) TabStGAusfertigung date: 15.07.2009 (BGBl. I S. 1870). URL: <https://www.global-regulation.com/translation/germany/392902/tobacco-tax-act.html>; Excise Duty Tables. Part III – Manufactured Tobacco / European Commission. 2018. URL: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/taxation/excise\\_duties/tobacco\\_products/rates/excise\\_duties-part\\_iii\\_tobacco\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties-part_iii_tobacco_en.pdf).

<sup>11</sup> Excise Duty Tables. Part III – Manufactured Tobacco (Tax receipts – Manufactured Tobacco) / European Commission. 2018. URL: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/taxation/excise\\_duties/tobacco\\_products/rates/excise\\_duties\\_tobacco\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties_tobacco_en.pdf).

because of the decline in the popularity of smoking. Applying this mechanism allows achieving the fiscal and regulatory objectives of the excise policy.

Of interest is also Spanish experience of ensuring the stability of tax revenues from cigarettes by reducing the dumping. On the eve of the adoption of Council Directive 2011/64/EU Spain experienced the greatest problems among member countries with the balance of public finances. The Spanish model of the anti-dumping mechanism, like the German one, provides for the payment of a higher excise duty when the maximum retail price of cigarettes is below a certain level. However, if in Germany this threshold corresponds to the weighted average retail price, in Spain it is fixed. In case the set price level is not achieved, a higher level (second fixed amount) of the minimum excise duty is applied. In other words, the Spanish model, unlike the German one, does not provide for a stepwise increase in the additional excise tax as the maximum retail price of cigarettes decreases. At the same time, the double minimum excise tax in Spain applies to both cigarettes and tobacco for smoking: the excise tax on cigarettes must be at least EUR 131.5 per 1,000 pieces and is increased to EUR 141 if the maximum retail price is less than EUR 196; the excise duty on tobacco for smoking must be at least EUR 98.75 per 1 kg and is raised to EUR 102.75 if the retail selling price is less than EUR 165 per 1 kg.<sup>12</sup>

The problem of dumping in the cigarette market is also relevant for Ukraine. In the context of a sharp increase in excise rates in Ukraine in 2016–2018 dumping prices increasingly distorted market competition and limited the achievement of fiscal and regulatory objectives of excise policy. Moreover, a further increase in excise rates on tobacco products by 20% annually during 2019–2025 was associated with the risk of further complicating the situation. This intensified the development of an anti-dumping mechanism to ensure the stability of tax revenues from cigarettes.

In order to solve the problem of cigarette undervaluation, stabilize excise tax revenues and improve their forecasting, the Ministry of Finance of Ukraine developed a draft law to make amendments to clause 221.2 of Article 221 of the Tax Code of Ukraine. It was proposed to add the following paragraph: “When determining the tax liability for cigarettes according to codes according to UKT ZED 2402 20 90 10, 2402 20 90 20, the size of the declared maximum retail price, which is less than the minimum excise tax on the number of pieces of cigarettes in a package, multiplied by the coefficient 1.65, the amount of excise tax must not be less than the established minimum excise tax liability multiplied by a factor of 1.4”.

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<sup>12</sup> Spain Corporate – Other taxes / PWC. URL: <http://taxsummaries.pwc.com/ID/Spain-Corporate-Other-taxes>.

Analyzing this initiative, we can state that it corresponds to the current European trend of using the anti-dumping mechanism to stabilize excise tax revenues. It reminds the Spanish system of increased minimum excise duty on cigarettes whose maximum retail selling price does not reach a certain level established by law.

In addition, it was proved that the anti-dumping mechanism proposed in Ukraine has significant advantages over the corresponding German one. If a German-style anti-dumping mechanism had been introduced in Ukraine, an additional excise duty would be paid on all cigarettes that cost less than their weighted average retail selling price. Provided that in 2018 this price in Ukraine, calculated on the basis of data on prices and volumes of sales of these excisable goods in 2017 (as provided for by Council Directive 2011/64/EU), was UAH 24<sup>14</sup>, cigarettes would be subject to additional excise tax costing up to UAH 23.99 per pack. However, the ad valorem excise duty in 2018 in Ukraine was applied to cigarettes, the maximum retail price of a pack of which exceeded UAH 32.54. Nevertheless, this did not prevent certain manufacturers from declaring maximum retail prices, in which the non-tax part was even negative. Such low prices are economically unreasonable (they exist primarily due to tax abuse), but they were declared, which made it possible to sell the corresponding “shadow” tobacco products at legal points of sale.

Therefore, it was concluded that the introduction of the German anti-dumping mechanism in Ukraine to ensure the stability of excise tax revenues would have neither a fiscal effect, nor a regulatory influence. This instrument is effective in Germany, where excise duty rates are relatively stable and there is no spike in the weighted average retail price of cigarettes due to the increased fiscal role of excise taxes.<sup>15</sup> This conclusion is also relevant for Moldova.

Both anti-dumping fiscal mechanisms – used in Germany and provided for by the legislative initiative of the Ministry of Finance of Ukraine – have the same economic essence: if the maximum retail price of cigarettes falls below a certain

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<sup>13</sup> On Amendments to Article 221 of the Tax Code of Ukraine on Peculiarities of Tobacco Products Taxation: Draft Law of Ukraine of April 20, 2018. URL: <https://www.minfin.gov.ua/news/view/proekty-rehuliatomykh-aktiv-dlia-obhovorennia-?category=aspekti-roboti>.

<sup>14</sup> According to estimates by the Ukrainian Center for Tobacco Control, the average price of a pack of cigarettes in Ukraine in 2017 amounted to UAH 23-24 (see: Average prices for cigarettes in 2018, if a law is adopted to raise the tobacco excise tax to the EU level, could increase by a quarter – up to UAH 30 per pack – experts / UNIAN. URL: <https://press.unian.ua/press/2259281-seredni-tsini-na-sigareti-u-2018-rotsi-v-razi-priynyattya-zakonu-pro-pidvischennya-tyutyunovogoaktsizu-do-rivnya-es-mojut-zrosti-na-chvert-do-30-grn-za-pachku-eksperti-foto-video.html>).

<sup>15</sup> Korotun V.I., Koschuk T.V. Antidumping mechanism for stabilizing tax revenues from tobacco products. Finances of Ukraine, 2018. No. 9. P. 60–72.

level, an additional excise duty must be paid. However, unlike the German model, pegging the maximum retail price of cigarettes to the minimum excise tax liability using an economically justified coefficient in the Ukrainian fiscal mechanism would significantly reduce the attractiveness of declaring abnormally low maximum retail prices, which would allow selling suspiciously cheap cigarettes at legal points of sale without violating current legislation. The disappearance of such “shadow” segment of the Ukrainian tobacco market would significantly complicate access to cheap cigarettes, which would help achieve health care goals and increase tax revenues. In addition, an increase in the average selling price of cigarettes on the legal market would create conditions for an increase in VAT, retail excise tax and, in the case of an increase in prices for brands in the middle price segment, ad valorem excise tax. If, as a result of the change in the pricing policy of cigarette manufacturers, their revenues rose, there would be an increase in profit tax revenues. But unfortunately, this anti-dumping initiative was not adopted in Ukraine.

Having considered the international experience, we will formulate a proposal for addressing the dumping problem of the development of the tobacco market in Moldova and guaranteed growth of excise revenues to the state budget. It is based on the fact that in Moldova it is better to avoid using mechanisms that significantly complicate tax administration for tax authorities and taxpayers. The easiest way to solve this problem would be to return to the practice of the MRP for cigarettes and cigarillos.

When the MRP is introduced in Moldova, cigarettes at an abnormally low price will not get into legal points of sale, which will create preconditions for an increase in prices for these excisable goods with a corresponding increase in VAT, ad valorem excise duty and profit tax. Higher prices for cigarettes and cigarillos will also reduce their illegal exports to the EU. Other advantages of the MRP implementation are: 1) higher budget revenues; 2) decrease in cigarette affordability, which is important for achieving health care goals; 3) transfer of the tax burden to the adult consumer of tobacco products; 4) creating conditions for improving the predictability of excise tax revenues and reducing the risk of growth in the budget deficit; 4) reducing of unfair competition in the tobacco market.

An important condition for the minimum retail price for cigarettes and cigarillos is the correct threshold and mechanism of indexation. Given the structure of the excise tax in Moldova, it is important that the level of the minimum retail price for cigarettes and cigarillos be set at a level that includes all mandatory tax revenues (excise duty, VAT), the minimum cost of production, minimum delivery costs, and generally accepted trade margins for retailers. Considering that

manufacturers and importers, whose products will be sold through retail at the minimum retail price, will pay only the minimum specific excise duty (excluding the ad valorem component), the “price threshold” of this segment will be able to guarantee the transfer of excise tax to the consumer, reduce the affordability of the segment, and as a result, an increase in prices for more expensive cigarettes and cigarillos (it is also possible to predict an increase in revenues from excise duty on more expensive products, on which the ad valorem component of the excise duty will also be paid).

Another important element of the minimum retail price is the indexation mechanism. It seems appropriate to have annual indexation of the minimum specific excise rate. This will provide an annual increase in retail prices and prove that the government is taking effective measures to reduce the affordability of the cheapest tobacco products such as cigarettes and cigarillos.

**The introduction of the minimum retail price in addition to an annual increase in excise rates also reduces fiscal incentives for smuggling cigarettes from Moldova to EU countries.**

More than 25% of illicit cigarettes in EU countries, the origin of which can be determined, come from Belarus, Moldova, Russia and Ukraine. This is over 10 billion cigarettes a year, and about half of them are “cheap whites”. According to the European Commission, the reasons for this are significant differences in prices between the EU member states and neighbouring countries, including Ukraine and Moldova, which have signed an association agreement with the EU. In this regard, the EU welcomes increasing of excise rates, as it is believed that this will reduce the fiscal incentives for cigarette smuggling.

For many years, Moldova has been one of the largest suppliers of counterfeit cigarettes and “cheap whites” cigarettes to the EU countries. According to the data of KPMG's Stella report, in 2019, 6% of all “cheap whites” cigarettes were supplied from Moldova, the growth rate of the volume of these cigarettes in 2018 was at the level of 36.4%, but in 2019 an opposite process was observed – the drop was almost 47% (table 1). **Notably, 2019 was the third year in a row when there was a practice of applying the minimum retail price for cigarettes in Moldova.**

**Table 3**

### Deliveries of contraband and counterfeit cigarettes from Moldova to the EU during 2015–2019

Indicators	2015	2016	2017	2018	2019
1	2	3	4	5	6
The volume of the illicit cigarette market in the EU, billion pcs.	53	48.3	44.7	43.6	38.9
of which “cheap whites” cigarettes, billion pcs.	19.8	16.4	14.2	13	13.8
The number of cigarettes smuggled from Moldova to the EU, billion pcs., including	1.1	0.9	1.1	1.5	0.8
“cheap whites” cigarettes, billion pcs.	1.01	0.82	1.09	1.38	0.71
counterfeit cigarettes, billion pcs.	0.09	0.08	0.01	0.12	0.09
Share of the total illicit cigarette market in the EU, %	2.1	1.9	2.5	3.4	2.1
Growth /decline rate,%	100	81.8	122.2	136.4	53.3

*Source:* Illicit Cigarette Consumption in the EU, UK, Norway and Switzerland / *KPMG*. 2020. 237 p. URL: <https://www.stopillegal.com/docs/default-source/external-docs/kpmg-report---2019-results/kpmg-report-illicit-cigarette-consumption-in-the-eu-uk-norway-and-switzerland-2019-results.pdf>.

#### Weaknesses

**The growth rate of excise tax rates is significantly higher than the growth rate of household income, which leads to a substitution effect on the market – the transition of smokers to the low price segment. Despite the annual increase in excise duty, prices for products in the low price segment do not change, which leads to loss of VAT and profit tax, and does not correspond to the goals of public health.**

According to Oxford Economics, annual inflation in Moldova for the period 2018-2020 averaged 3.9%. Real wage growth averaged 8% per year. However, in Moldova there is a negative dynamics of the economically active population, including the employed population and the unemployed. According to the National Bureau of Statistics, in 2020, 867.3 thousand people were economically active, which is -5.7% compared to 2019. In 2020, employed people amounted to 834.2 thousand, which is 4.4% less than in 2019. At the same time, there is an increase in the economically inactive population – from 1.126 in 2019 to 1.178 thousand people in 2020, or by 4.6%. Economically inactive population mainly includes

pensioners, students, people at working age engaged in households and those working abroad. Thus, the economic burden on the working population is increasing. According to Oxford Economics, real household incomes in 2019 grew by only 1.5%, and due to the Covid-19 pandemic in 2020, this figure was -6.5%. According to the GFK, along with Ukraine and Kosovo, Moldova is the country with the lowest income of the population in Europe. Based on the data of the National Bureau of Statistics, it takes 9 days to work in Moldova to buy an average consumer basket per person per month, and almost 60% of income is spent on food and utility bills.

As a result of the growth of excise taxes at a rate more than the inflation, the increase in real prices for cigarettes averaged 12.2% annually; therefore, the affordability of cigarettes for the consumer has significantly decreased in recent years. In Moldova, the share of the cost of cigarettes in GDP per capita is 5% (calculated as the ratio of the cost of purchasing 2,000 cigarettes of the best selling brand to GDP per capita). For comparison, in Romania and Ukraine it is 3.7% and 3.6%, respectively, in Lithuania, Latvia and Estonia – 2.3-2.4%, in Germany – 1.6%. Compared to developed countries in Moldova, this indicator is now the highest.

The affordability of cigarettes approached the level of 25% of the average income in Moldova. In developed countries, this figure does not exceed 15%. When the indicator exceeds 15% of income, in order to minimize their own expenses, the consumer's desire to buy illegal products or move to other more affordable segments or categories increases. It is worth noting that in Ukraine, due to the significant annual increase in excise taxes, the affordability of cigarettes for the consumer has also considerably decreased and currently is 25% of the average income. At the same time, in Ukraine, the share of the illegal market in 2021 reached its peak, 18.1%. The main sources of illegal products are those intended for sale in Duty Free and for export, and counterfeit products. Significant costs of paying excise duty by legal producers and consumers at the same time create an economic opportunity for unscrupulous economic agents who evade taxes in order to make a profit. Illicit trade reduces the effectiveness of tax regulation of the tobacco market and distorts market conditions. For instance, in Ukraine, an increase in prices for legal cigarettes by 10% (which may be the result, for example, a higher tax) leads to an increase in their share of illegal turnover by 12.2%. In Moldova, the market share of illegal cigarettes is still quite low. On the other hand, a substitution effect is observed – the transition of consumers to the low price segment, represented by cigarillos and cigarettes below cost. The market share of the low-

price segment has been increasing since 2020 and in 2021 reached 30%, which contradicts not only fiscal goals, but also the goals of public health.

**A possible tool for protecting the taxable base of excise tax from reductions by decreasing the cost of products could be the application of minimum retail prices for cigarettes and cigarillos, as already mentioned above.**

An excise policy to increase excise duty rates in the short term should take into account the risks associated with an undervaluation of the tax base used to calculate VAT and excise tax payments, and, accordingly, prices by cigarette manufacturers in order to become more competitive in the tobacco market. This, on the one hand, constrains the rise in prices for tobacco products with a negative impact on the ad valorem component of excise duty, VAT and profit tax, and on the other hand, does not reduce the affordability of these excisable goods, which is another barrier to the achievement of health care goals.

In the context of the post-crisis increased fiscal role of excise taxation of cigarettes, many EU countries, in particular, Italy, Germany and France, experienced problems with collection of the planned volumes of excise tax revenues due to the undervaluation of cigarette by certain tobacco companies, which negatively affected the overall growth. The presence of cheap cigarettes on the market, despite the increase in the excise burden on them, did not contribute to a decrease in the popularity of smoking either.

### **Moldova has a poor system of state control over the production and circulation of tobacco products**

In 2020, President of the Republic of Moldova, Maia Sandu, spoke of the lack of state measures to combat the shadow market of cigarettes and, in particular, their smuggling. Today there is a need to improve the efficiency of the mechanism for tracking the supply chain of tobacco, tobacco products and manufacturing equipment. In addition, it is necessary to increase responsibility for offenses in the sphere of illegal production and trafficking of tobacco products, to ensure the termination of the activities of organized criminal groups in the sphere of illicit circulation of tobacco products. **Given a significant increase in excise duty and the price of cigarettes, the benefits in the production and distribution of illicit products have grown and will continue to grow.** It is necessary to keep records of statistical information on the revealed facts of offenses in the field of excise policy by state fiscal and law enforcement agencies in the context of specific indicators. It

is essential to improve the level of material and technical support of customs and border police. **In addition to developing the institutional environment in combating and countering the illegal production and circulation of tobacco products, it is important to eliminate the fundamental reasons for the emergence of this market.**

### Threats

**The most likely is the continuation of the trend of replacing tobacco products with a high level of excise taxation with cheaper alternatives and further distribution of products on the market below cost.**

In Moldova, in view of the low purchasing power of the population, there is a substitution effect on the tobacco market – a transition to products of a low price segment, which in 2021 reached 30% of the market share. The government proposes introducing a minimum effective rate for cigarillos, which should increase prices for this category. On the other hand, this proposal does not define measures to regulate the segment of cigarettes at below-cost prices, which is likely to continue to grow in 2022. Despite the annual increase in excise taxes, prices for products in this category do not change, which does not correspond to the goals of public health.

In 2018, the World Bank noted the following about Moldova’s experience in tobacco control: “... a key lesson from their recent experience is the need for countries to simplify tax structures by merging multiple tobacco tax “tiers” and unifying the tax rate across all types of cigarettes. This can help to preempt smokers’ switching to cheaper cigarette brands after a tax-rate hike on the brands they previously smoked. While Moldova saw a reduction in cigarettes consumed from 2016 to 2017, there was a noticeable shift during this time in people’s consumption to non-filter cigarettes, which are taxed at lower rates than filter cigarettes and cost less.” The shift in consumption continues to this day in favor of the lower price segment.

It is also possible that demand will shift in favor of roll-your-own tobacco products, the so-called roll-ups, which replaced the demand for cigarettes on the legal Moldovan market due to their significantly lower excise burden. After an almost 8-fold increase in excise tax rates on fine-cut tobacco for the rolling of cigarettes in 2019, legal tobacco for roll-ups lost ground. However, according to the monitoring data of the most popular websites, a wide range of illegal tobacco is also presented on the market. Certainly, unlicensed manufacturers have a competitive price advantage due to the absence of excise. Due to the cost competitiveness of

roll-ups made of illegal raw materials, they are becoming widespread. It is rather difficult to estimate the volume of such products on the market, since with the development of e-commerce and delivery services, they are freely sold through the Internet on unofficial sites.

There is also a risk of illicit cigarette circulation, which is caused by differences in taxation of tobacco products in Chisinau and Tiraspol. Illegal circulation of tobacco products in the form of “cheap whites” cigarettes is a key threat in the uncontrolled territory of Moldova. This is due to the excessive import of cigarettes to the Transnistrian region (in 2020, about 1.7 billion cigarettes were legally imported), which are subsequently illegally distributed both in Moldova and in the EU countries, where the level of excise duty is much higher.

### **A sharp increase in the illegal market for tobacco products**

According to Ipsos data, the share of the shadow market for tobacco products in Moldova in 2021 (first wave of surveys for February-March) is rather low – 2.3% in the total structure, while in the region on the border with Ukraine this indicator is several percentage points higher. In neighbouring countries, this indicator is much higher. The most common forms of illegal trade in tobacco products are the production of cheap “illicit whites” or “cheap whites” cigarettes, as well as the sale of duty free cigarettes. There is a risk of increased sales of tobacco products using e-commerce means (websites, telephones, various applications and e-mail, etc.) without a license and paying adequate taxes. The spread of illicit trade in tobacco products through e-commerce, especially in the context of the COVID-19 pandemic, makes the issue of regulatory regulation of online-trade in tobacco products and the introduction of appropriate control mechanisms relevant and urgent in Moldova. Illegal traders create fake websites where they sell illegal tobacco, counterfeit and contraband tobacco products, including violating the legislation on delivery for minors and non-compliance with the time frame for sale. In such conditions, it is quite difficult for law abiding companies to prove that they are not involved in the violation.

**A moderate indicator of the shadow market for tobacco products in modern conditions should not inspire the authorities with calm. The experience of the countries of the Balkan region, the Baltic States and Ukraine shows the risks of a sharp increase in illegal products on the market, which may be 18% or more.** The experience of Ukraine, which raises the excise tax on tobacco by 20% annually, is a safeguard and handbook. If in 2016 the share of the shadow market in

the overall structure was about 1%, then in 2021 it broke all records and rose to 18.1%.

The losses of the state budget of Ukraine are estimated in the equivalent of the Moldovan national currency – MDL 9.66 billion, which is 35% higher than the total amount of excise taxes in Moldova. Moreover, in 2020, the size of the illegal market in Ukraine was 6.9%. The constant gap in the growth rates of prices for tobacco products and the growth rates of household incomes caused a decline in the index of affordability of legal products on the market. The total amount of tax payments (excise tax, VAT, 5% retail excise<sup>16</sup>) on a pack of cigarettes is MDL 26.6. Moreover, the market is full of offers of cigarettes at the price of MDL 20.1 and MDL 24.8, which is lower than the minimum tax rate. The share of such products is constantly growing and has already reached 18.1% of the legal market, and the loss of the state budget, the so-called tax gap in the excise tax on tobacco products, is estimated at UAH 14.4 billion, which at the current exchange rate is about EUR 480 million.

A fall of solvent demand automatically leads to an increase in illegal products on the market, and this is the main risk for the state in the future. Illegal trade, in addition to budget revenues losses and reduced effectiveness of public administration, involves easy access of minors to tobacco smoking; money from illegal trade is used to finance further illegal activities.

**An effective and prudent policy of excise taxation provides for an increase in excise rates by 1.5–3 percentage points higher than the income of the population. In the case of sharp increases in rates, that is, “excise shocks”, consumers often choose illegal products, which are much cheaper. A reduction in the legal turnover of cigarettes slows down the growth rate of the excise tax, and leads to its decrease in future.**

Due to the annual increase in excise rates at rates exceeding inflation by an average of 3.8 times, for 2018–2020, the volume of the legal cigarette market in Moldova fell significantly from 4.43 to 3.51 billion pieces, by 20.7%. This trend is continuing in 2021 and in the future the rate of decline will be higher, which will reduce the rate of growth of excise tax. At the same time, according to the WHO global report, the current trends in the prevalence of tobacco use among the Moldovan population aged 15 years and older over 2000–2025 show an average

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<sup>16</sup> From 01.01.2015 in Ukraine, in order to strengthen the revenue side of local budgets, an excise tax on retail trade of such excisable goods as particular, alcoholic beverages, tobacco products and fuel was introduced. From 01.01.2017, the excise tax on the retail sale of fuel has been transferred to the basic rate of excise tax paid by manufacturers and importers.

growth rate of 0.84%. The World Bank data also suggest that the share of the smoking population in Moldova is not decreasing, but in comparison with 2016 increased by several tenths of a percentage point. Ukraine has a similar situation, the decline in the cigarette market is about 40%. In the draft state budget of Ukraine for 2022, for the first time, revenues from the domestic excise tax on tobacco products are projected to be 5.5% lower than the 2021 project, despite the increase in tax rates by 20%. This is despite the fact that the Accounting Chamber of Ukraine pointed out serious shortcomings in excise tax revenues forecasting techniques. **When developing the state excise policy, it is important to take into account the index of the affordability of legal tobacco products on the market and its change in dynamics.** The nominal average price of a pack of cigarettes (given the share and prices of cigarettes in the premium, medium, and cheap segment) in Moldova over the past three years has nominally increased by more than 40%, the real one has grown by 36%, which significantly exceeds the growth of household incomes. As a result, the cigarette affordability index declined. It is important to understand that a sharp decrease in this indicator causes a decrease in legal turnover and an increase in the supply of illegal tobacco products to the market.

Further manipulations on the part of the operators of the tobacco market as a result of the use of specific approaches to the excise taxation of certain types of tobacco products are possible. By setting different rates of excise tax on tobacco products, depending on the characteristics of the product or packaging, the state creates risks of receiving less tax revenues to the budget because of the illegal acts of unscrupulous business entities. An example is the so-called “cigarillo/cigar schemes”, which were identified by the tax authorities of Ukraine based on the analysis of reported data on the risks of misuse of excise stamps. In particular, certain market operators reduced their tax liabilities for excise tax by manipulating the number of pieces of products in a pack (application of excise tax stamps intended for packs of cigarillos of 2 pieces, to packs of cigarettes of 20 pieces), as well as changing the visual appearance of tobacco products with a higher level of excise taxation in categories with a lower tax rate (for example, the tax burden on cigarillos by the beginning of 2021 was 67% less compared to cigarettes, which led to the presentation on the market of cigarillos that do not visually differ from cigarettes). As a result of such manipulations, the loss of the state budget of Ukraine during 2018–2020 estimated at up to EUR 53.5 million (MDL 1,063.8 million). One option to mitigate these risks is to amend the excise policy and apply a uniform tax rate.

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**Insufficiently high correlation between the increase in excise tax rates and the consumption of tobacco products (due to the expansion of the illegal market share or the continuing transition of smokers to the low price segment)**

The dualism of the priorities of the state excise policy in the field of tobacco products is to ensure budget revenues and reduce the consumption of tobacco and tobacco products. For transition economies in the face of the COVID-19 pandemic, it is extremely important to ensure stable tax revenues. In general, in 2020 taxes and fees provided 63.6% of the revenues of the consolidated budget of Moldova. The excise tax amounted to 16.3% of the total amount of tax revenues, and the excise tax on tobacco products is 6.4% of the collected taxes, which together with VAT gives 8% of budget revenues from the tobacco industry.

At the same time, the consumption of tobacco products, due to the increase in the price of cigarettes and the decrease in effective demand among the population, is moving to more affordable alternatives. Thus, the goals of public policy will not be fully achieved.