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THE FISCAL REFORMS OF TOBACCO MARKET IN ITALY AND GREECE: TOWARDS AN EXCISE CALENDAR

**Foreword by
GIORGIO DI GIORGIO**



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SEPTEMBER 2017



Thanks to British American Tobacco Italia
for the contribution to the production of this Booklet.

BRITISH AMERICAN TOBACCO ITALIA

British American Tobacco Italia S.p.A. (BAT Italia) was officially established on 1st January 2002 and took its current set-up in June 2004, following the merger with ETI S.p.A.. BAT acquired ETI S.p.A. after winning the tender for privatisation on 16th July 2003. Such privatization represented the greatest investment ever done in Italy by an international Company (2.3 billion Euro).

Thanks to its Italian spirit mixed up with an international perspective, BAT Italia has been playing a relevant and strategic role in the national economic scenario. In Italy – the second largest market in Europe – BAT commercializes over 20 international brands such as Rothmans, Lucky Strike, Dunhill and some national brands, such as MS, to mention a few. BAT Italia also commercialises a wide range of vaping products with the brand *Vype* which includes ePen, Pebble, eBox and eTank.

Our Company provides a significant contribution to the growth of the Italian economy, ensuring about 2.5 billion Euro per year in terms of tax revenue.

In 2017, BAT Italy was awarded, for the sixth consecutive year, the “Top Employer Italy” certification as well as the “Top Employer Europe 2017” certification, only granted to those multinational companies which are certified in at least 5 European countries.

BAT Italia is part of British American Tobacco Group, one of the most international of the sector: operating in over 200 markets with a leading role in 60 Countries, BAT commercialises over 200 brands and employs over 50,000 people all over the world.

BAT Group has been active from several years in the Next Generation Products sector (the so-called “NGP”), at global level. The Company developed innovative nicotine delivery devices for adult smokers, produced according to the highest quality standards. The main areas of activity in this sector concern *vaping products* (namely e-cigarettes) under the *Vype* label and the Tobacco Heated Products (tobacco products including no combustion process) such as “*glo*”.

Over the last 5 years, BAT invested at global level over 1 billion Dollars in Next Generation Products and is today the biggest vaping company at European and at global level (USA and China excluded).



FOREWORD

In Italy, the retrospective assessment of legislative measures is typically an undervalued exercise. Nevertheless, the Italian Legislator have recognised the importance of this practice and have established, that it is in many cases compulsory by law (“Regulation on the implementation of the Regulatory Impact Assessment (RIA)”). To date, as observed by the Presidency of the Council of Minister, RIA has only been conducted 20 times in the three years between 2013 and 2015.

Given the importance, at least in theory, of a retrospective assessment of legislative interventions, the Law also establishes the procedure for conducting a reliable and informative RIA, following international best practices. These guidelines are very important, especially in cases where the assessment concerns technically complex and politically far-reaching legislative interventions.

The document drawn up by CASMEF with the support of British American Tobacco Italia is worthy of close attention because it is one of the rare examples of the meticulous carrying out of an RIA: it is as if CASMEF researchers voluntarily took on a responsibility that should be public and decided to carry out the role, so exalted in other international contexts, of public servants. Moreover, since the assessment relates to a legal measure that is crucial both for the public accounts and for public health, as it is the case of the 2015 tobacco fiscal reform, the document takes on even greater significance.

In the first instance, the document is striking in its total compliance to the principles set out by Italian legislators for the performance of the RIA: such compliance ensures that the results are valid and entirely objective. But even an excellent RIA cannot shake off an obvious criticism: as economies are complex systems, no RIA can compare the results of the measure assessed retrospectively with those of an alternative measure not yet implemented. To prevent such criticism, the document includes a Regulatory Impact Assessment on the tobacco reform adopted in Greece in 2012. It is true that the Greek context was and is different from the Italian context, but carrying out the two RIAs together allows us to make a comparison which, at least in the intentions of the CASMEF researchers, is similar to that performed in the laboratory between the final results of two different treatments.

The results are very interesting, indeed.

What emerges from the RIA on the Italian reform is the acknowledgement that the measures adopted performed well during the first two years of their implementation: volumes and revenue were stabilised, contraband was kept under control and competition dynamics were respected. However, significant critical points emerge from the Italian RIA, with regards to the vagueness of legal basis underlying the discretionary interventions on the taxation parameters. It is the typical “*rules versus discretion*” debate so dear to monetary economists which, in the tobacco context, takes on a new form: discretionary power which is not clearly defined risks generating decisions imposed by the urgency of a very short time frame (as in the case of the recent budget corrective action), which can destabilise the market in the medium-long term. Moreover, on an oligopolistic market as is the tobacco market, discretion opens the way to manufacturers applying pressure on institutions in a manner that is not always entirely correct. Unequivocal rules, especially in the case of a mature market with stable and easily predictable long-term trends, would appear to be desirable and according to CASMEF should feature in a new reform.

The other suggestion proposed by the document concerns the comparison between the Greek case and the Italian case: in particular, the need for gradual and non-drastring interventions is clear. In fact, even if it is acknowledged that tobacco taxation should be more specific-based rather than proportional in order to ensure the State’s revenue and to bring about higher margins for high-price products, such a transformation should take place gradually to avoid shocking the established equilibrium. If this happened, the dominant players would exploit their position at the expenses of consumers and, at the same time, would pave the way to contraband.

To sum up, the exercise conducted by the CASMEF researchers shows the path for future tobacco taxation: unequivocal rules and gradual implementation to ensure the mediumterm stability of the sector shall be carried out, until major transformations are introduced in the very near future. These major transformations are partly due to changes in demand, greater awareness of health risks, but, above all, it will be the result of innovation of supply, now ready to deliver returns on investments made on alternative products.

Prof. Giorgio Di Giorgio
CASMEF Director
Luiss Guido Carli University

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INTRODUCTION

- More than two years after the entry into force of the reform of tobacco excise duty in Italy (2015), an analysis of the results obtained seems necessary.
- The taxation of tobacco products pursues the ambitious aim of balancing apparently conflicting objectives:
 - maximising tax revenue, which is directly proportional to the quantities consumed;
 - protecting the public health, which is inversely proportional to the quantities consumed;
 - protecting competition, which must be guaranteed in any free market.
- The need to reconcile these apparent conflicting goals has led to a structured excise duty system based on a balance between:
 - the specific component, whose role is to ensure revenue for the State's coffer irrespectively of sale prices and to ensure the regressiveness of the taxation, desirable in the case of goods considered to be harmful;

- the proportional component, which enables the Treasury to collect some of the margins arising from sale at high prices;
 - a minimum collectible tax, which should penalise sale at prices that are lower than a threshold considered to be appropriate.
- The 2015 reform made substantial changes to the method of calculating the three basic parameters, linking it closely to the weighted average price trend. The initial choice, basically approved of by all the market operators, was an example of equilibrium which led to encouraging results:
 - The tax revenues were stabilised, recovering considerably compared with the years prior to the entry into force of the reform;
 - Volumes fell slightly, in line with the long-term trends typical of all industrialised countries;
 - Market competition was protected; between 2015 and 2017 the difference between the highest prices and the lowest prices was sufficiently wide, ensuring affordable consumption alternatives (despite the current economic crisis) and discouraging the migration of demand towards illegal products.
- Despite its good structure, however, the reform turned out to be lacking from the point of view of its management over time. Indeed, apart from the automatic adjustment mechanisms linked to the weighted average price trend, excessive room for discretion (among other things based on vague and difficult-to-interpret legal presuppositions) was left to the competent Administration (AAMS – *Agenzia delle Dogane e dei Monopoli* [Italian Tobacco Commissioner]), simultaneously leading to the following:
 - high medium-term unpredictability and uncertainty concern-

ing tax policies, whose trend is one of the basic parameters on which market operators base their growth and investment strategies;

- poor interpretation of the possibility of benefiting from the power of discretion offered to institutions, which has led several manufacturers to exert strong pressure to protect their own economic interests.
- The decisions made in June 2017 indicate that the initial idea of the reform, based on seeking equilibrium, is foundering. The reason for this should be sought precisely in the incorrect interpretation of the legal basis on which discretionary interventions should be based, especially when the revenue generated by tobacco products is essential for balancing the public accounts.
- The aim of this research is to conduct a thorough assessment of the reform, using the typical model for Regulatory Impact Assessments (RIA). Actually, it should be mandatory for an assessment of this kind to be carried out by institutions identified as being competent by the government (in this case there is no doubt that the AAMS would be the body assigned for this).
- In the absence of an “official” RIA, the analysis contained in this document covers all the necessary steps for its performance, showing the strong and weak points of the current legal framework and suggesting the necessary innovations to improve it.
- To make the results of the Italian reform even more evident, it was also decided to carry out a RIA on the excise reform introduced in Greece in 2012. Among other things, as the Greek model was supported by some experts in the field in Italy too, it seemed natural to compare the two reforms using the same assessment models.
- A comparison between the two RIAs shows that:

- the Greek reform cancelled the sustainability of the market, upsetting established equilibrium and causing revenue to plummet (also encouraging the development of a flourishing illegal market);
- the Italian reform ensured stability and equilibrium, at least for as long as discretionary interventions were characterised by moderation and equilibrium.
- Some clear conclusions emerge from this analysis:
 - the time has come for a new intervention on the regulation which will offer market operators stable prospects, reducing the discretionary nature of interventions and implementing unequivocal rules at least for the medium term;
 - the challenge is to bring about balanced and gradual changes (not sudden changes like those imposed in Greece), for which the references must be both the sector's history in Italy and other successful international experiences;
 - the reference point certainly cannot be Greece, nor can it be countries in which the indiscriminate exacerbation of tax pressure has generated a flourishing illegal market with obvious harm to both the Treasury and consumers' health.

THE TOBACCO MARKET IN ITALY

During the last few years, the Italian tobacco market has been transformed by new consumption choices and new legislative frameworks.

On the demand side, there has been an overall reduction in sales, mainly concentrated in the highprice segments. This reduction has been accompanied by a moderate increase in tax revenue as a consequence of the recent reform.

Current situation

Prices and volumes

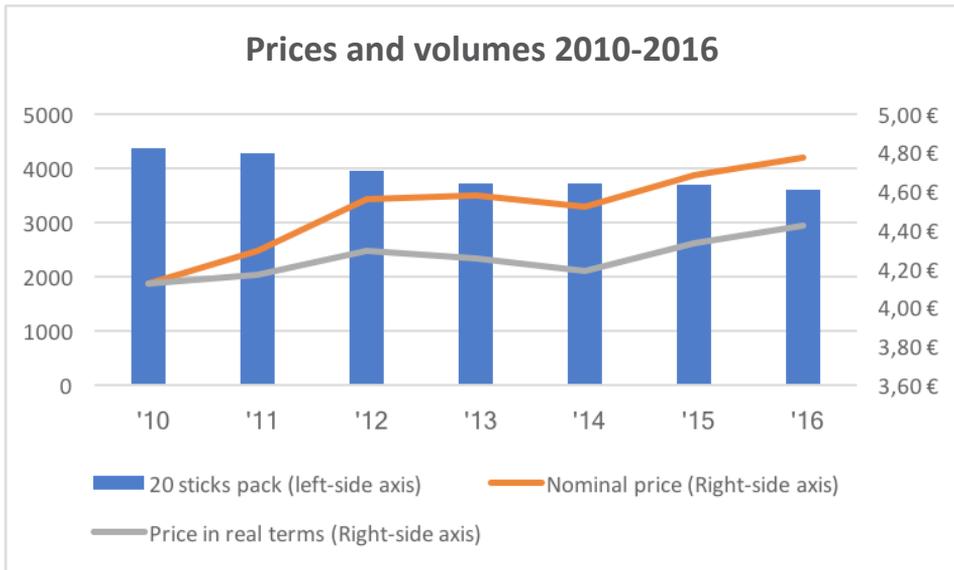
During the 2010-2016 period, cigarette consumption decreased from 87,000 to 72,000 tonnes, a reduction of 17%, the equivalent of about 750 million packets of 20 cigarettes. 20% of this loss was reabsorbed by the fine-cut tobacco market.

Over the same period, the average final price of 20-sticks package increased from about €4.10 to €4.80. Of these 70 cents, 40 are in line with

the general increase in consumer prices. Net of inflation, so in real terms, the price therefore increased by 30 cents.

Figure 1 shows the trend over time of the tobacco quantities consumed and the nominal and real prices¹. The increase in prices (in particular the real price) *partly* explains the reduction in demand.

Fig. 1 - The average market price, nominal and real, and tobacco volumes from cigarettes sold in the 2010-2016 period.



Source: CASMEF studies based on Nielsen data.

During the same period, the consumption of fine cut showed a considerable and relatively stable growth: from 1.44 tonnes consumed in 2010 to 3.42 tonnes in 2016. The increase from 2010 to 2016 was 137% (i.e. the volumes more than doubled): equivalent to an average annual growth rate of about 15%.

It is important to emphasise that the increase in consumption of fine cut was exponential until 2012, when it reached the level of 3.1 tonnes.

¹ If the nominal price trend had only reflected inflation, the orange line would have been flat.

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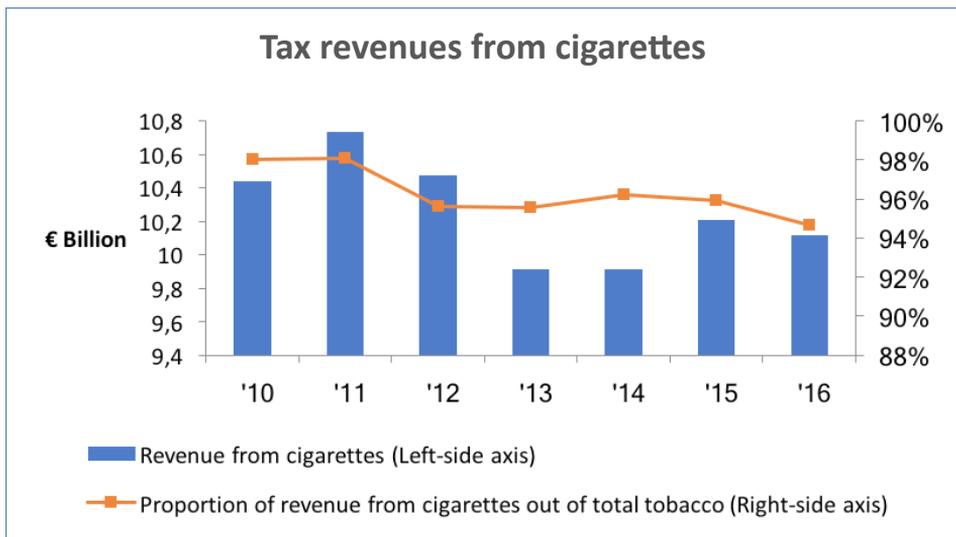
From then onwards, the overall growth was “just” 10%, with an average annual rate of 2.5%.

Tax revenue

The contribution to the State’s coffers from tobacco products has remained relatively stable over the last few years, fluctuating between a minimum of €10.3 billion in 2014 and a maximum of €10.9 billion in 2012.

The revenue generated by cigarettes represents nearly all the tobacco tax revenue, even if its market share has decreased slightly, from 98% in 2010 to 94% in 2016. Figure 2 shows the trend in tax revenue from cigarettes and its proportion of the total tax revenue from tobacco.

Fig. 2 - Tax revenue from cigarettes and relevant proportion of tobacco revenue.



Source: Total revenue from Italian Ministry of Economic Affairs and Finance data, cigarette revenue from CASMEF studies based on Nielsen data.

Due to the reduction in consumption, the revenue from cigarettes fell slightly to below €10 billion in 2013-2014. Although sales decreased in

the following two years, the new tax regulation introduced in 2015 enabled the revenue to increase to around €10.2 billion.

The tax revenue dynamics did not follow those of consumption as the total incidence of excise duty increased from 58.5% (July 2014) to 58.7% (January 2015). Most importantly, the reference price for calculating excise duty changed: up until the 2015 reform, the reference was the *Most Popular Price Class (MPPC)*, whereas now it is the *Weighted Average Price (WAP)* of the entire market.

Analysis of demand and future prospects

The general decline of the market was accompanied by a shift by consumers to the lower segment (so-called downtrading); for this reason, the sensitivity of demand to price variations appears more significant for some specific segments than for the market as a whole. Despite downtrading, the elasticity of market demand is greater than one, implying percentage variations in volumes which are more than just proportional (and of the opposite sign) compared with percentage variations in the average price.

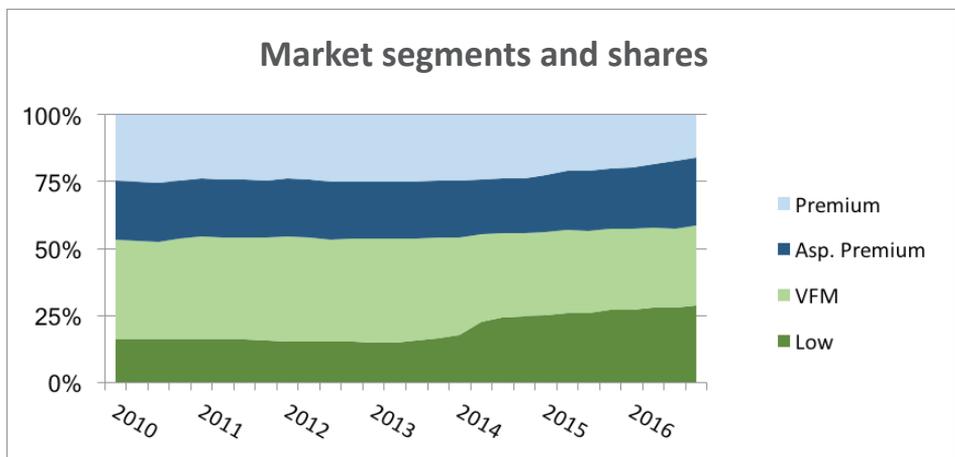
Market shares and downtrading

The Italian cigarettes market includes four segments, identified on the basis of sale price. The four segments represent different price bands and are called, from the lowest price band to the highest: *Low*, *Value for Money*, *Aspirational Premium* and *Premium*. The market shares of the different price segments remained stable until the beginning of 2014: the *Value for Money* and *Premium* segments took shares of 37% and 25% respectively, leaving 22% and 16% for the *Aspirational Premium* and *Low* respectively.

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In 2016 the situation was very different, as it can be seen in Figure 3, which shows the quarterly trend of the market shares. The long down-trading phase led to a current snapshot in which the lower price classes represent 60% of the market (29% for *Low*, 30% for *Value for Money*), and the *Aspirational Premium* (currently 25%) benefited from the large reduction of *Premium* (fell to 16%).

Fig. 3 - Quarterly market shares of the Low, Value for Money, Aspirational Premium and Premium segments.

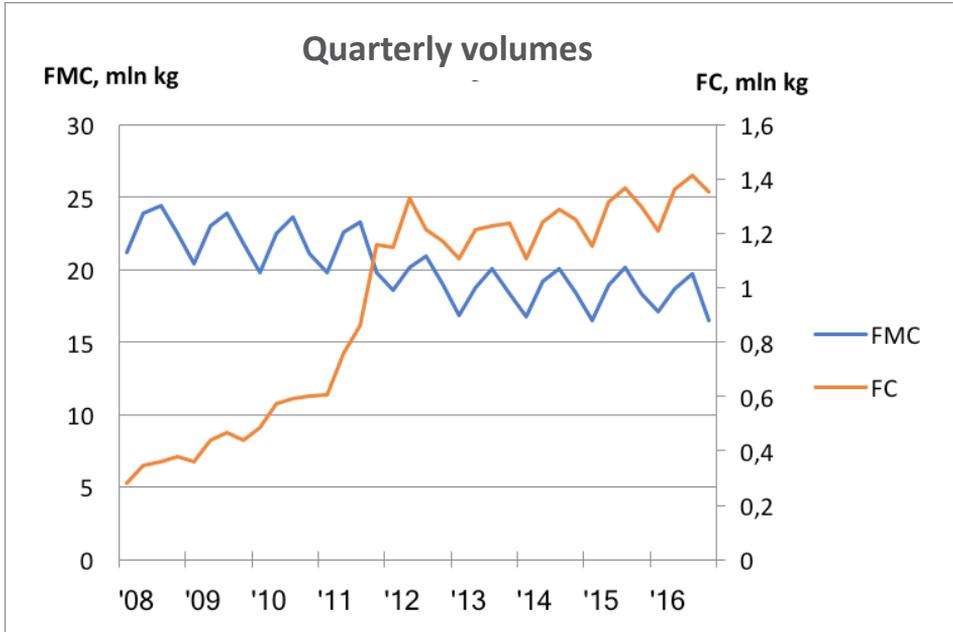


Source: CASMEF studies based on Nielsen data.

From 2013, a set of factors changed the balance between the different segments; among these factors, the reduction in consumer purchasing power following the financial crisis was certainly significant. The fall in income (in some cases perceived not as temporary, but permanent) slowly shifted consumer demand towards lower-priced products: the demand for tobacco products was no exception and the industry followed this downward trend. In fact, as often happens following a reduction in overall demand, competition between manufacturers shifted onto price: the prices of some products (usually positioned in the upper segment)

were reduced and new products entered the market in the *Low segment*. Figure 1 shows the reduction in WAP in 2014.

Fig.4 – Seasonal trend of cigarettes and fine cut consumptions quarterly observations.



Source: CASMEF studies based on Nielsen data.

In view of the significant reduction in income due to the financial crisis, the reduction in WAP was not sufficient to prevent some of the demand shifting towards fine cut. Figure 4 compares the seasonal trend for the consumption of cigarettes (FMC) and fine cut (FC): it is interesting to note that the consumption of FC (orange line), apart from increasing significantly, also acquired the seasonality typical of cigarettes (FMC, magenta line). This observation suggests that the new consumers of fine cut were previously consumers of cigarettes.

Basically, fine cut could be considered a fifth segment, capable of attracting younger consumers, given their lower propensity to spend and greater adaptability.

In order to be able to compare the consumption of fine cut with the consumption of cigarettes, by convention the quantities of fine cut are converted into equivalent quantities of cigarettes by a conversion factor of 1.25. In other words, 1 kg of FC is considered equivalent to 1.25 kg of FMC.

By applying the above-mentioned conversion factor, the market share of the fifth segment in 2016 was 7%, whereas in 2010 it was 3%. To better understand the extent of the phenomenon, it is worth noting that the consumption of fine cut managed to reach half of that of Premium segment cigarettes.

Elasticity of demand

The long-term elasticity estimates, drawn up by CASMEF, show a stable trend above one, suggesting that an increase in the real price over the last few years has had negative effects on volumes that were more than proportional.

Table 1 shows the trend of estimates for the market as a whole. The greater the elasticity (in absolute value), the greater the sensitivity of quantities to price variations. It is obvious that other shocks on demand (such as those linked to the health warnings on the packs) may lead to effects that cannot be quantified on the basis of elasticity.

Tab. 1 - Estimate of long-term elasticity of demand for cigarettes at average market price, expressed as an absolute value, calculated on monthly data from December 2008.

Elasticity of cigarette demand			
	'14	'15	'16
Market elasticity	1.07	1.25	1.09

Source: CASMEF study based on Nielsen data.

Unlike the aggregate market, the elasticity of the individual segments is very marked, as the downtrading analysis suggested. Among other things, there was an increase in long-term elasticity from 2015 for all the price segments.

The size of the demand for *Premium* cigarettes is highly price sensitive. Generally speaking, over the last few years, demand has also become more sensitive to changes in the price of *Aspirational Premium*, confirming the downtrading trend.

The demand for *Aspirational Premium* cigarettes is very reactive to the price of Value for Money and Premium cigarettes, suggesting that consumers migrate to and from both closest price segments.

The demand for *Value for Money* cigarettes depends mainly on the price of *Low* cigarettes, which are their natural and convenient substitute.

Table 2 summarises the long-term elasticity values for the individual segments.

Table 2. Estimates of long-term elasticity of the segments expressed as an absolute value, calculated on monthly data from December 2008.

Elasticity of demand for cigarettes per segment			
Segment	'14	'15	'16
Premium*	1.51	2.51	2.06
Aspirational Premium**	2.58	1.98	1.97
Value for Money***	0.47	0.90	1.01
Low****	2.82	3.08	2.54

Source: CASMEF study based on Nielsen data. Values calculated with: * the average market price for 2015 and the price of *Aspirational Premium* for 2016; ** the prices of *Premium* and *Value for Money*; *** the price of *Low*; **** the price of *Value for Money*.

Conclusions

Our overview of the Italian tobacco market may be summarised as follows:

- the quantities sold show a long-term negative trend, as is the case in all industrialised countries;
- consumers, as they have the possibility of doing so, tend towards the lower price segments;
- the fine cut shows a positive and stable trend;
- following the recent reform, the revenue from cigarettes appears stable despite the reduction in volumes, but its proportion of the total revenue from tobacco products is decreasing;
- the aggregate market demand is elastic; for the high-price segments, it is even more elastic.

These conclusions suggest that increases in tax pressure which are not adequately planned and/or adjusted in relation to market requirements could lead to a reduction in consumption and in tax revenue, irrespective of the long-term dynamics. In view of the current sensitivity of demand, an increase in prices would not only encourage the downtrading process, but could also encourage an expansion of the illegal market, which is more likely to take place in a context of widespread weakening of consumer purchasing power.

ANTI-TOBACCO LEGISLATION AND INNOVATIVE PRODUCTS

Since the beginning of the 2000s, anti-tobacco legislation in Italy has become gradually tougher. In particular, European Directives aimed at protecting the health of smokers and non-smokers have been transposed into Legislative Decree No 184 of 24 June 2003 and Legislative Decree No 6 of 12 January 2016. Indeed, smoking bans have been introduced in all public places to protect non-smokers from passive smoking; in addition, restrictions have been imposed on packaging, nicotine content and the content of other substances present in cigarettes, and warnings of various kinds have been included on packets to dissuade consumers, especially young people, from consuming tobacco-based products.

Legislative Decree No 6 of 2016 completely replaced the preceding Legislative Decree No 184 of 2003. The main changes introduced in 2016 concerned the following points:

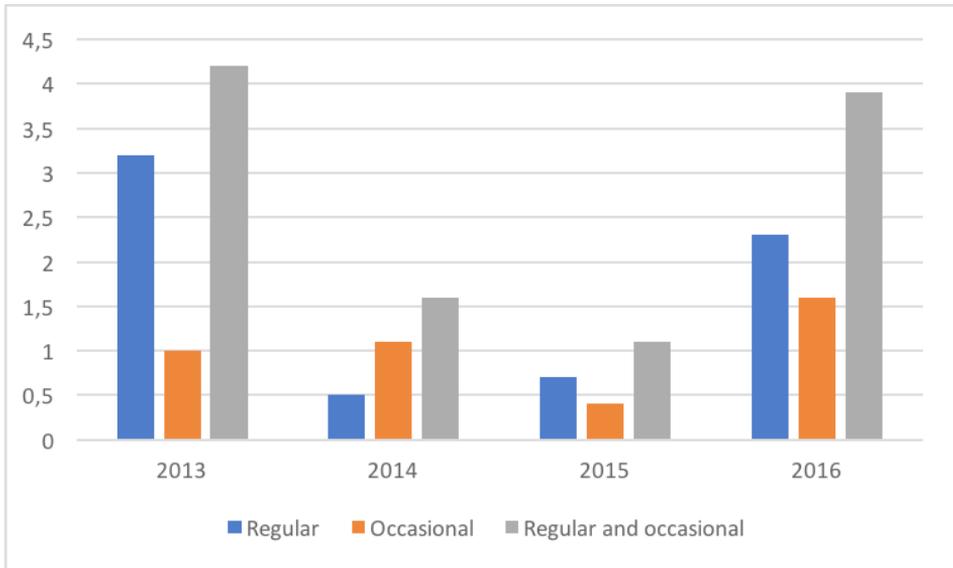
- inclusion, on packs of tobacco products, of health warnings consisting of text, colour photograph and free telephone number to call to stop smoking;
- abolition of 10-sticks packets and fine cut packs of under 30 grams of tobacco;
- ban against including information on the tar, nicotine or carbon monoxide content on the labels;
- ban against using additives that could make the tobacco product more appealing;
- ban on smoking in motor vehicles in the presence of pregnant women and minors;
- ban on smoking outside paediatric, obstetric and neonatal care hospitals;
- toughening of sanctions on the sale and administration of tobacco products to minors.

If on the one hand the toughening of anti-tobacco legislation has contributed to reducing the consumption of tobacco products, on the other hand it has boosted the growth of a new market for next-generation products, such as electronic cigarettes and devices which heat tobacco without generating combustion.

In Italy, the electronic cigarette started to be developed from 2010, with a real commercial boom in the three years between 2011 and 2013, followed by a steep decline in 2014-2015. The number of users (regular and occasional) of these devices fell from more than 2 million in 2013 to just over 500,000 in 2015 (Figure 5). In 2016, due also to the introduction of new devices, which offer better standards of quality and safety,

the number of electronic cigarette users increased considerably, almost to 2013 levels.

Fig. 5 - Number of electronic cigarettes users in Italy as a percentage of the adult population.



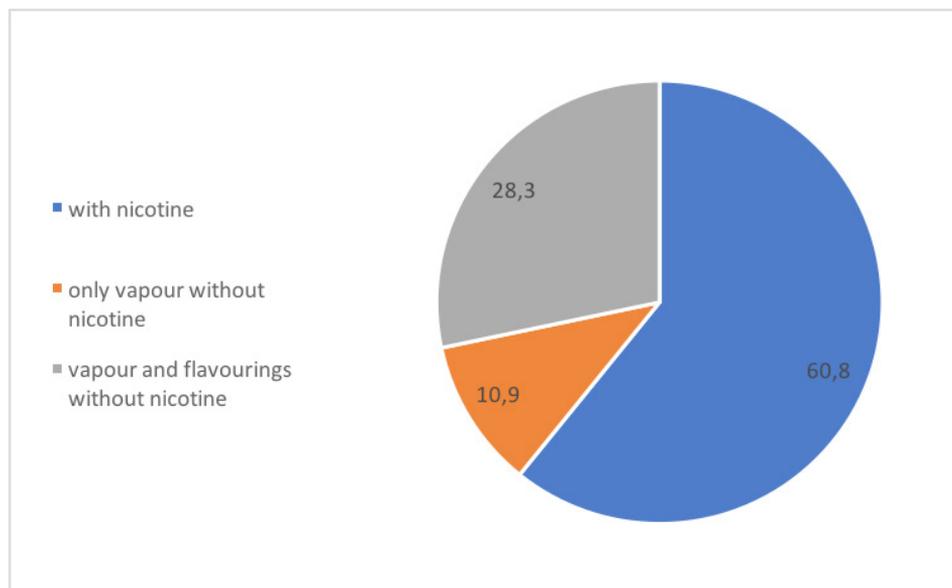
Source: Doxa-ISS 2016 survey.

Although there are many models on the market, electronic cigarettes can be divided into three categories: disposables (20%), rechargeables with battery and disposable cartridge (35%) and modular (45%), more sophisticated than the other two, with interchangeable components and tanks that can be refilled by the user.

The wide range of products on the market offers liquids that can be inhaled with or without nicotine and with or without flavourings. In 2015 about 61% of the population of so-called “vapers” used liquids with nicotine and 39% liquids without nicotine (Figure 6).

Fluctuating market trends indicate that electronic cigarette consumers are fairly heterogeneous in type.

Fig. 6 - Type of electronic cigarettes used in Italy (2015).



Source: Doxa-ISS 2016 survey.

According to the Doxa-ISS 2016 survey², most electronic cigarette users continue to smoke conventional tobacco products: as shown in Figure 7, the percentage of dual smokers was 90% in 2013 and has never fallen below 73% (data recorded in 2015); this proportion then rose to about 78% in 2016.

In particular, compared with traditional cigarettes, nearly 43% of the persons interviewed declared that they had started or resumed smoking, 15% had instead reduced the consumption of conventional cigarettes, 19% had not changed their habits, 10% had never smoked tobacco and nearly 8% had stopped doing so.

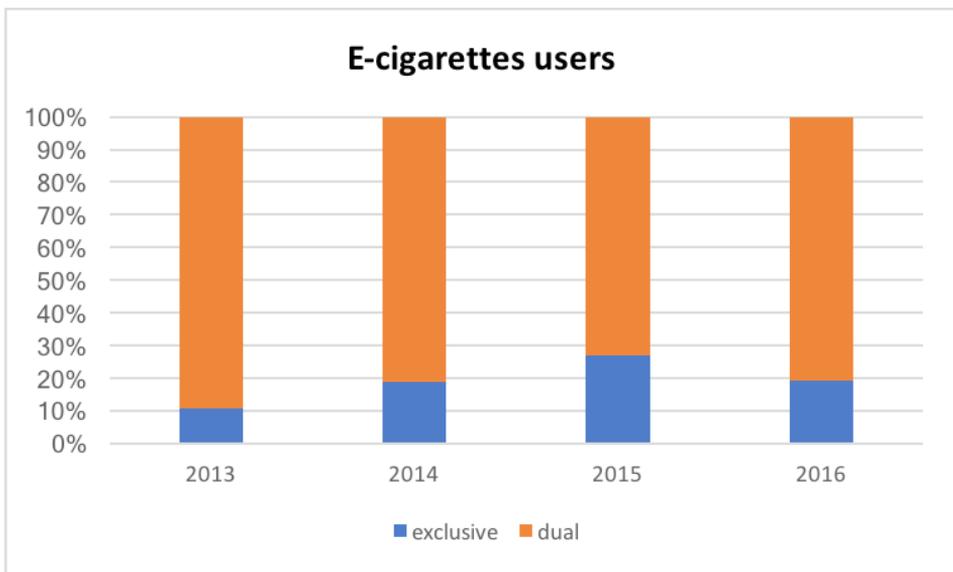
According to a survey conducted by Ernst & Young³, in 2016 electronic

2 *"Il fumo in Italia"* ["Smoking in Italy"]. Public opinion survey conducted by DOXA on behalf of the Istituto Superiore di Sanità [Italian National Institute of Health] in collaboration with the Istituto di Ricerche Farmacologiche Mario Negri [Mario Negri Pharmacological Research Institute], March 2016.

3 *Electronic Nicotine Delivery System (ENDS): an update or a rapidly evolving vapour market*. Report 2,

cigarette users in Italy are typically people over thirty years of age: in particular, only 19% of users are in the 18-29 age band, while 42% are in the 30-44 age band and the remaining 39% in the 45-64 band. With regard to the gender distribution of users, the same survey showed that electronic cigarettes are used in basically equal proportions by men (51%) and women (49%).

Fig. 7 - Exclusive and combined users of electronic cigarettes in Italy.



Source: Doxa-ISS 2016 survey.

Despite the see-sawing trends in the number of electronic cigarette users in Italy, the survey sponsored by Ernst & Young showed that the number of regular vapers has been increasing rapidly over the last few years: for example, in 2016 the percentage of regular consumers settled at around 45%.

However, the market may still be considered very young. The survey's data show that most vapers have only recently joined the market: in actual fact, only 14% of the interviewees had been using electronic cigarettes for more than two years, 32% for one or two years and 53% for less than one year.

Official data on the turnover produced by the market for Next-Generation Products are not available also because of the considerable fragmentation of the supply, divided among manufacturers of the devices, liquids and cartridges and the differentiated sales network. However, there is reason to believe that this market will grow considerably in the near future, especially in high-income countries, which adopt very severe anti-tobacco policies.

In this respect, the recent analysis conducted by Euromonitor International⁴ forecasts that between now and 2021, the worldwide turnover of Next-Generation Products, i.e. electronic cigarettes and heat-not-burn products (HNB), will increase from the current US\$12.3 (equivalent to around €10.8) billion to approximately US\$34 (equivalent to around €29.8) billion.

In particular, the study suggests that heat-not-burn tobacco products will be decisive in the growth dynamics of the future tobacco market. In fact, heat-not-burn tobacco products will see the biggest growth within Next-Generation Products, and will become the largest category of the latter. In addition, set against an estimated loss of US\$7.7 (equivalent to about €6.7) billion on conventional cigarettes, the heat-not-burn products market alone will increase by US\$12.3 (equivalent to around €10.8) billion. According to the forecasts, this will enable the tobacco market as a whole to increase by about 1% between now and 2021.

These forecasts on Next-Generation Products are supported by the

⁴ *Latest Research: What the 2017 Edition Tobacco Data is Telling Us*. Published on 26 June 2017.

consideration that worldwide, electronic cigarette consumers increased by 86% between 2013 and 2015, and according to some estimates in some countries, such as the United Kingdom, electronic cigarette consumers could exceed consumers of conventional cigarettes within a few years. A massive growth of this kind could also happen in Italy, mainly due to greater product diversification.

The expansion of the electronic cigarette market should also be analysed in the light of the potential benefits for tax revenues. For example, since 2015 the Italian government has recorded in its budget sales tax receipts of €85 million.⁵ Yet the revenue was (incredibly) only €5.2 million⁶ in 2015 and €3.4⁷ million in 2016. It is therefore clear that the growth in the electronic cigarettes market should be accompanied by a radical increase in tax collection efficiency. This appears all the more urgent since the problem is clearly defined. As the tax obligation is due from the moment when the product leaves the excisable goods warehouse, the problem refers to a population of 139 parties in addition to the excisable goods warehouses owned by Logista S.p.A.

Also, in this respect, the challenge for the regulator will be to draw up a regulatory framework that balances the different interests. The regulator's interests include continuing to protect public health and the correct perception of the risks by consumers. Taxing the product remains an important operative instrument, in both absolute and relative terms compared to conventional products.

5 Bill submitted by the Italian Minister of Economic Affairs and Finance, presented to the President's office on 25 October 2015: State budget for the financial year 2015. Bill approved by the Senate of the Republic on 20 November 2015 submitted by the Italian Ministry of Economic Affairs and Finance: State budget for the financial year 2016 and budget for the three-year period 2016-2018.

6 Source: Minister of Economic Affairs and Finance, Question time in Commission VI Chamber, Legislative Finance Office, Enquiries Department, Ministry of Economic Affairs and Finance, Reply Statement to the Hon. Busin, 25 February 2016.

7 Treasury Summary Account at 30 December 2016. Statement of Treasury debits and credits (01/03/2017-Extraordinary Supplement No 3).

In this respect, the European Commission (Directorate-General for Taxation and Customs Union) issued a public consultation⁸ which showed that 90% of participants, most of whom also smoked electronic cigarettes, were of the opinion that the electronic cigarette sector should not be taxed. Only 4% believed that any taxation should be equivalent to or higher than that on conventional cigarettes. The percentage increased to 24% when demand was for heat-not-burn tobacco products compared to conventional cigarettes. In addition, most people expect that a 50% increase in the price of refills would shift consumption towards conventional products or alternative purchasing solutions (online purchases, contraband). The answers to the questionnaire suggest that, although next-generation products are perceived differently from conventional cigarettes, at the moment excessive taxation would have a considerable effect on this emerging market.

8 Public consultation - *Excise duties applied to manufactured tobacco*. 7686 subjects of whom 67.69% declare that they use electronic cigarettes.

**REGULATORY
IMPACT
ASSESSMENT:
ITALY**

The current Italian taxation on cigarettes and on other processed tobacco products is regulated by the Excise Consolidation Act (Legislative Decree 504/1995). The most recent amendment to the section on processed tobacco products was made by Legislative Decree 188/2014, which substantially restructured the taxation of this sector.

The impact of the reform on the sector's dynamics is complex, and evaluating it is rendered even more complex because some effects will become apparent in the medium-long term, in the context of a continuously evolving market.

The results of the reform must therefore be assessed using meticulous and thorough methodologies. The following sections discuss the impact of the reform on the market, basing the analysis on the best practices implemented at government level to measure the efficacy and efficiency of the regulatory solutions adopted. The proposed outline therefore follows that of Regulatory Impact Assessments (RIA). According to the current system, RIAs are detailed analyses with a standard structure based on six points, each of which expresses an assessment with regard to:

1. Achieving the goals
2. Costs
3. Resulting effects
4. Level of compliance with requirements
5. Critical points
6. Summary and conclusions

Basing an assessment on a standard structure enables the Legislator to have a clear and comparable reference between different sectors on the efficacy of a legal measure. The Regulatory Impact Assessment (RIA) is a scheme in Italian legislation which aims to retrospectively assess the effects of a regulation on citizens, companies and the public administration. This scheme is governed by Article 14 of Law 246/2005 and DPCM [Prime Ministerial Decree] 212/2009 together with the Regulatory Impact Analysis, a study which is conducted at the investigation stage of the legislative process, so before the regulation enters into force. The RIA is compulsory for all measures for which the Regulatory Impact Analysis is conducted, i.e. regulatory measures of the government and individual ministers, interministerial measures, bills on government initiative (except for cases of exclusion and exemption), and also legislative decrees and laws converting decree-laws into law. The RIA must be conducted at the end of the first two years from the date of entry into force of the law being assessed, and at two-yearly intervals thereafter. When conducting the RIA,

the various stakeholders need to be consulted in order to collect data and opinions from the parties affected by the regulations under examination.

It should be stressed that the RIA is not applied extensively to the whole area of competence. In the three years between 2013 and 2015, only 20 RIAs were submitted by the competent administrations to the Department for Legal and Legislative Affairs of the Prime Minister's Office and, to date, no RIA has been produced or submitted on the reform of taxation on tobacco products implemented by Legislative Decree 188/2014.

Focus: The 2015 excise reform

Italian tobacco legislation has incorporated European Union directives on the matter. These directives, aiming to harmonise the market rules between countries, have clearly set out the guidelines which national legislators should follow. In addition to the general principles of protecting public health and free competition, the directives established in numerical terms the limits of the parameters within which national governments can modify the rates for taxing tobacco products.

Italian legislators have recently reformed the sector with Legislative Decree No 188 of 15 December 2014. The decree modifies many fundamental aspects for the operation of the market.

Modification of excise duty: The total tax burden was increased to 58.7% of the weighted average price; the fixed duty was raised to 10%, and a minimum collectible tax of 170 euros per kilo (1,000 cigarettes) was introduced.

Traceability: In addition to a significant change in the excise duty arrangement, the reform introduced changes aimed at rationalising the sector, such as the obligation to set up an advanced system for monitoring logistics with product traceability.

New role for the AAMS: Some new tasks have also been introduced for the Tobacco Commissioner (AAMS), which has been called upon to put forward changes to the excise duty terms, within pre-established limits and on the basis of specifically identified economic presuppositions.

Budget perspective: Specific mention is made of the aim of maximising the total revenue from the sector, bearing in mind consumption and sale price trends.

The issue of achieving a balance between the specific component (which is independent of the sale price) and the component which is proportional to the price is of fundamental importance in the regulation of the sector, and even now European countries have different preferences regarding the incidence of the two components. These differences, which depend on the structure and development of the individual national markets, have in turn an impact on the market itself and on tax revenues.

For example, a low specific component leaves a wider margin for manoeuvre to manufacturers in establishing prices, thus encouraging competition, but at the same time makes the tax revenue more volatile in relation to price movements.

Note that in a situation such as this, the principle of protecting competition (possibility of lower prices) conflicts with that of protecting public health (with lower prices, demand increases). Furthermore, the increase in the specific component has greater repercussions on lower prices. Like other European countries, Italy adopts a system in which the proportional component is relatively predominant compared to the fixed component, although with a minimum level of taxation to be paid to the Treasury.

Section 1: Achieving the goals

In the current regulatory context, the Italian taxation system for cigarettes and other tobacco products should balance different objectives such as protecting the public health, preserving the sustainability of the public budget and ensuring market competition: these objectives involve several actors sometimes with conflicting aims. The need to find a compromise among the many significant public objectives is confirmed by European legislation: in particular, the aims of European legislation are stated in the text of Directive 2011/64 and are summarised in the following points:

- ensuring the correct operation of the domestic market;
- ensuring a high level of health protection.

It is also specifically reiterated that prices should be freely established for all tobacco products.

The specific aims of the Directive concerning processed tobacco products are included in the broader framework of the single market: that same Directive acknowledges that: *“one of the aims of the Treaty with regards to the European Union is to preserve an economic union which has similar characteristics to those of a domestic market in which there is healthy competition”*. Consequently, the structure of excise duty in each country should not skew competition conditions or the free circulation of products in the Union.

With regards to taxing the specific segment of cigarettes, the Directive shows that it is advisable to:

1. ensure neutral competition conditions for all manufacturers;
2. reduce market fragmentation;
3. highlight health objectives.

The innovations contained in the current Italian regulatory system, through Legislative Decree 188/2014, follow these principles and indicate the guidelines to be followed when determining the parameters relating to excise duty. The regulator assigns to Tobacco Commissioner (AAMS) the power to request corrective action from the Minister of Economic Affairs and Finance, with specific reference to the aims of revenue stability, bearing in mind price and consumption trends.

- 1. Competition.** The aim of ensuring the correct operation of the domestic market, by means of neutral competition conditions for all manufacturers, can be evaluated by examining market shares, as shown in Table 3. The table shows the mean data for 2014 together with the mean data for 2017 (up to March inclusive): the market is stably dominated by a group of three operators, Philip Morris International (PMI), Japan Tobacco International (JTI) and British American Tobacco (BAT), which in 2014 together represented 94.9% of the cigarette market, while for the first months of 2017 this percentage was 94% (about one percentage point lower).

Tab 3 - Market share before and after the reform.

	2014	2017
ITA	0.4%	0.3%
MIT	0.6%	0.8%
OTHERS	1.0%	1.1%
IMPERIAL TOBACCO	3.1%	3.8%
BAT	19.9%	18.9%
JTI	20.4%	23.6%
PMI	54.6%	51.5%

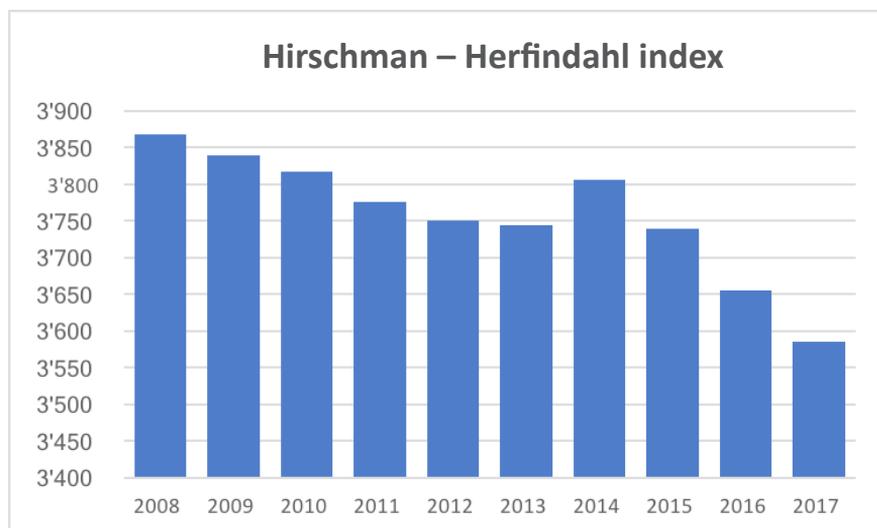
Source: Studies based on Nielsen data.

THE FISCAL REFORMS OF TOBACCO MARKET IN ITALY AND GREECE: TOWARDS AN EXCISE CALENDAR

Among the first three groups, both PMI and BAT have lost market share, 1% and 3.1% respectively, while JTI has expanded by 3.6% of the market. Nearly all the other manufacturers (except ITA) have gained market share, in particular Imperial Tobacco (+0.7%), MIT (+0.2%) and the “Others” category, which includes minor manufacturers, which has increased from 1% to 1.1% of the market.

An examination of the market shares shows that the sector appears to be heading towards less concentration. Further confirmation of this is given by an indicator widely used to analyse the competition conditions of a market, i.e. the *Hirschman-Herfindahl* index (H-H)⁹. This index, for which the trend in the cigarette market is shown in Figure 8, confirms that the market remains heavily concentrated: typically, a market with significant competition shows an H-H of under 1500. However, from 2015, the year when the reform entered into force, the concentration has clearly been decreasing.

Fig. 8 - *Hirschman-Herfindahl* market concentration index. The higher the number, the greater the concentration.



⁹ The *Hirschman-Herfindahl* index is calculated as the sum of the squares of market share.

A further indication concerning the absence of distorting effects of the reform is given by the width of the range of cigarette prices, i.e. the difference between the lowest price and the highest price for a packet of 20 cigarettes. Table 4 Shows the maximum and minimum prices from 2014 (before the entry into force of the reform) up to March 2017¹⁰. As may be observed, the difference in price between the most widely distributed products has become wider, from €1 to €1.20.

Tab 4 - Minimum and maximum prices prevalent on the market (products with sale volume of over 15,000 kg per month).

	2014	2015	2016	2017
MIN	4	4.2	4.2	4.2
MAX	5	5.2	5.4	5.4

Source: CASMEF studies based on Nielsen data.

The taxation structure introduced in 2015 therefore appears to have led to an increase in prices in the highest market band, enabling the prices in the lowest band to become even more differentiated, as shown in Table 4. This characteristic widens the range of products available to consumers, who, faced with less average product affordability (see the next section on the subject), can nevertheless remain active on the market. This possibility is the best defence against the illegal market.

- 2. Fragmentation.** The reform which entered into force in 2015 is basically in line with the aim of reducing fragmentation of the market, expressed by the European regulatory framework. In fact, in spite of the widespread fall in consumption, the introduction of a

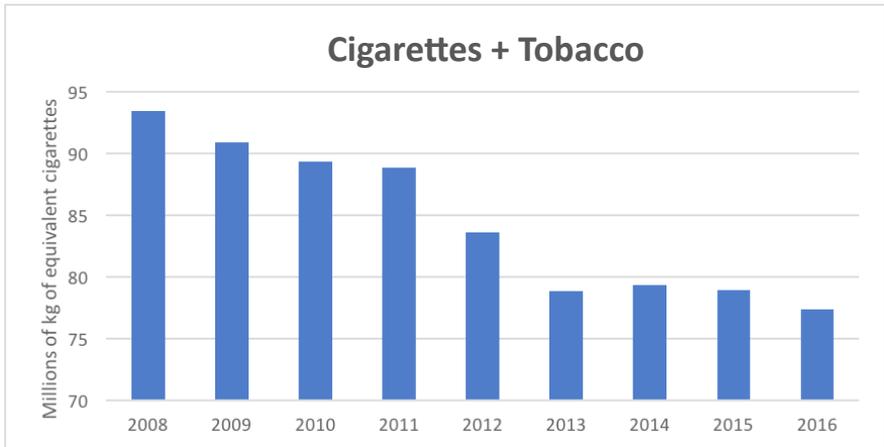
¹⁰ The calculation of this indicator excluded products which in the reference month recorded a sale volume of less than 15,000 kg. This was in order to avoid including spurious observations, or non-representative products or products in the course of depletion.

further price segment (in addition to the four already present) positioned below the current *Low* has been prevented¹¹. The current fragmentation of the Italian market also appears to be greatly diminished, suggesting a new segment arrangement. In particular, as there are no significant statistical relationships between the trends of the lower segments (*Low* and *Value for Money*) and of the higher segments (*Aspirational Premium* and *Premium*), it would seem correct to consider only two price segments (one below the average market price and one above), for which the market share remained basically stable in 2016. An analysis of the effects of the reform described below in the text shows that the dynamics of the market shares of the current segments reflect only a shift in demand within the two largest “aggregated” segments. Therefore, the reform does not appear to have caused significant flows of consumers from the high price bands to the low price bands; in actual fact if the Italian market can be considered to consist of only two price segments, a further reduction in fragmentation would contradict the aim of correct operation of the domestic market according to the principles of competition.

- 3. Health.** Cigarette consumption has been falling continuously for over ten years, except in 2014. Also including the data for fine-cut tobacco, cigarette consumption appears to be declining steadily, as shown in Figure 9. The percentage of smokers out of the total resident population aged over 14 years in 2016 increased slightly, after the marked drop between 2009 and 2014 (see Figure 10), although remaining at significantly lower levels compared with the 10 previous years.

11 A similar segment was observed, for example, in the Spanish market up until 2016 when the introduction of a selective (dual) excise duty led to its demise.

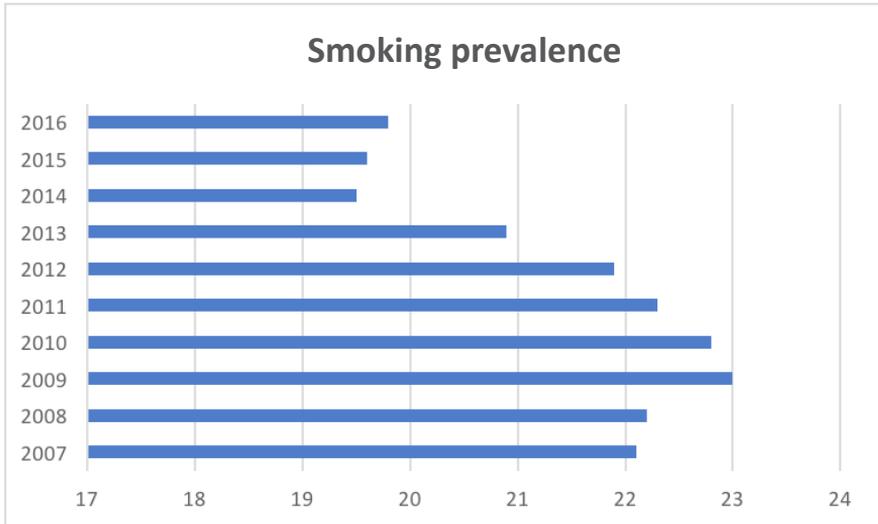
Fig. 9 - Volume of cigarettes and fine-cut tobacco expressed in equivalent cigarettes.



Source: CASMEF studies based on Nielsen data.

The effect of the reform therefore appears to reinforce the pre-existing negative trend. It should also be considered that ISTAT [National Institute for Statistics] recorded, with observations up to 2015, a gradual reduction in the number of cigarettes smoked per day and a definite reduction in the so-called “heavy smokers” (i.e. those consuming more than 20 cigarettes a day). It is plausible, therefore, that health trends have deeper structural causes and that they reflect the effect of cultural factors that go beyond taxation in general and the recent reform in particular.

Fig. 10 - Percentage of smokers out of the population aged over 14 years.



Source: ISTAT.

Section 2: Costs assessment

The reform, changing the tax profile, has led to higher costs for the operators in the sector. This increase is due to the higher tax burden, which has generated higher prices.

Therefore, consumers have also borne some of the increased costs caused by the reform: in particular, citizens have had to face increased prices and consequently, lower affordability of the consumable.

Table 5 shows the percentages corresponding to each of the parameters directly or indirectly determined by the regulator, all calculated on the average price of the year in question. The incidence of the specific

component, calculated on the total taxation (i.e. the sum of total incidence and VAT) increased from 5.8% in 2014 to 7.6% in 2017. However the corresponding reduction of the proportional component did not offset this increase: in 2017, 76.7% of the average price of a packet of cigarettes consisted of taxes (excise duty and VAT), whereas in 2014 it was 76.3%. As a result, the proportion destined for the manufacturers fell from 13.7% to 13.3%.

Tab 5 - Components of the cost of a packet of cigarettes of average price (as percentages).

	2014	2015	2016	2017
Price per 20-sticks package	4.52	4.66	4.76	4.79
Specific	5.8%	7.4%	7.5%	7.6%
Proportional	52.5%	51.0%	51.0%	51.0%
VAT	18.0%	18.0%	18.0%	18.0%
Tobacconists' margin	10.0%	10.0%	10.0%	10.0%
Manufacturers' margin	13.7%	13.5%	13.4%	13.3%

Source: CASMEF studies based on Nielsen data.

Due to the higher taxation, the price of cigarettes increased more than proportionally compared to income, leading to lower affordability of the product: in other words, for the same income, the cost burden for cigarettes increased. Table 6 gives the percentage variations of one of the indices which can be used to measure the level of affordability, i.e. the ratio between the weighted average price of cigarettes recorded on the market and the mean employment income.¹² Bearing in mind that the higher the index the lower the affordability, it may be observed that from the time of implementation of the reform onwards, the index increased by 3.2% in 2015 and 2.4% in 2016, confirming that the weighted average price increased more than in proportion to income.

¹² Other indicators may be created considering different variables instead of average employment income, such as average income or median disposable income of the family unit.

Tab. 6 - Affordability index: incidence of the average price of cigarettes out of internal employment income per unit of employment income. Percentage variations from the previous year.

	Affordability index (% variation)
2009	1.7%
2010	0.6%
2011	3.1%
2012	5.7%
2013	-0.7%
2014	-1.3%
2015	3.2%
2016	2.4%

Source: CASMEF studies based on Nielsen and ISTAT data.

In addition to the tax, the reform changed the structure of the institutional context in which the companies in the sector operate, and defined a new role for the Tobacco Commissioner (AAMS). In this respect, the reform generated higher costs for the Public Administration which may be summarised in the following points:

- **Monitoring.** The reform includes among the institutional duties of the AAMS the continuous monitoring of the average market price, understood as the mean of the prices of the individual products weighted according to quantities sold. This average market price is called Weighted Average Price (WAP)¹³. The new duties required adjustment of the Tobacco Commissioner (AAMS) technical capability for market analysis. In addition, after the entry into force of the reform, taking into account the trends in consumption and sale prices,

¹³ The weighted average price (WAP) is determined annually by 1st March of the subsequent calendar year, on the basis of the ratio, expressed in rounded-off euros, between the total value calculated with reference to the sale price including all taxes of cigarettes inserted into the consumer market in the previous calendar year, and the total quantity of the same cigarettes.

and also in order to ensure that the highest possible net income is achieved, the Agency (AAMS) Director takes the initiative to put forward to the Minister of Economic Affairs and Finance changes to:

- basic proportion (i.e. total incidence), increasing (or decreasing) it by a maximum of 0.5 percentage points;
- fixed proportion, increasing (or decreasing) it by a maximum of 2.5 percentage points;
- minimum collectible tax , increasing (or decreasing) it by a maximum of €5/kg.

The profile of the changes the AAMS may propose to the Minister, although innovative and a responsibility for the Agency, still appears ambiguous and needs to be determined in further detail by legislators. The section on the critical features of the reform deals with this issue, and in particular points out that the limits as to quantity and time scale of the discretionary powers granted to the AAMS are not clear.

- **Monopoly.** The reform maintains (and partly reinforces) the costs associated with the fact that there is a monopoly on warehouse management via the distributor Logista Italia. In order to obtain uniform and centralised information on trends of flows to and from the warehouses, the management of the newly-reformed system continues to be entrusted to a single company which operates as a monopoly. The persistence of this situation leads to a cost in terms of lost earnings for the community, as the benefits of a competitive market are renounced. A monopoly holder maximises its own income by applying a higher market price than the price that would be obtained from several companies with lower market power. Warehouse management also involves a further “opportunity” cost, i.e. a cost resulting from a lack of alternative choice: excise du-

ties are paid by manufacturers at the time when the product leaves the warehouse; they are collected by the warehouse manager, who pays them to the Treasury one month after collection. This leads to a cost in terms of lost income from the sums held by the manager (or of higher costs borne by the Treasury which has to resort to debt in order to dispose of required sums in advance, the cost of which is determined by the market interest rate).

- **Traceability.** The reform introduces the obligation to adopt, again on the initiative of the Director of AAMS, “*provisions concerning the traceability of these products and legitimising their circulation to consumers*”. The specifically stated aim is to improve the efficacy of duty-not-paid (DNP) prevention by means of a modern traceability system. This entails higher costs at all stages of the entire system, from manufacture to transport and safekeeping, up to marketing, in order to monitor the legitimacy of all the processes involved and to maximise collection of the relevant receipts.

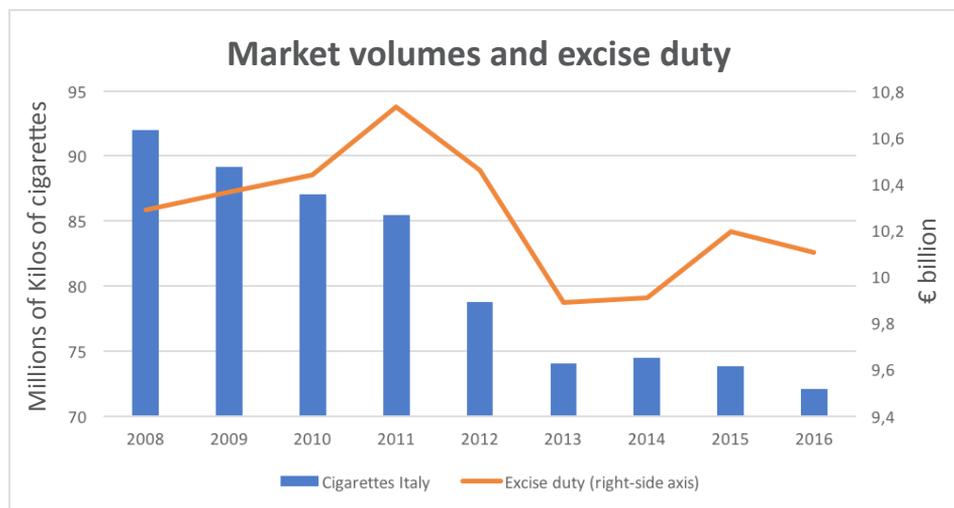
Section 3: Resulting effects

On the whole, the market has reacted positively to the entry into force of the reform. The reduction in consumption is consistent with the long-term trends applicable to all industrialised countries, and therefore the positive aspects should be sought in the overall equilibrium that the reform has been able to maintain, by modifying various requirements.

As shown in Figure 11, in the two years of enforcement of the reform, excise duty revenue decreased less than in proportion to volumes, or even increased, as in 2015. In particular, Table 7 shows that, while in 2015 and 2016 market volume decreased by 0.8% and 2.4% respectively, the rev-

Revenue from excise duty actually increased by 2.9% in 2015 and decreased by only 0.9% in 2016.

Fig. 11 - Volumes on the cigarette market (y-axis) in millions of kg. Revenue from excise duty (x-axis) in billion euros.



Source: CASMEF studies based on Nielsen and AAMS data.

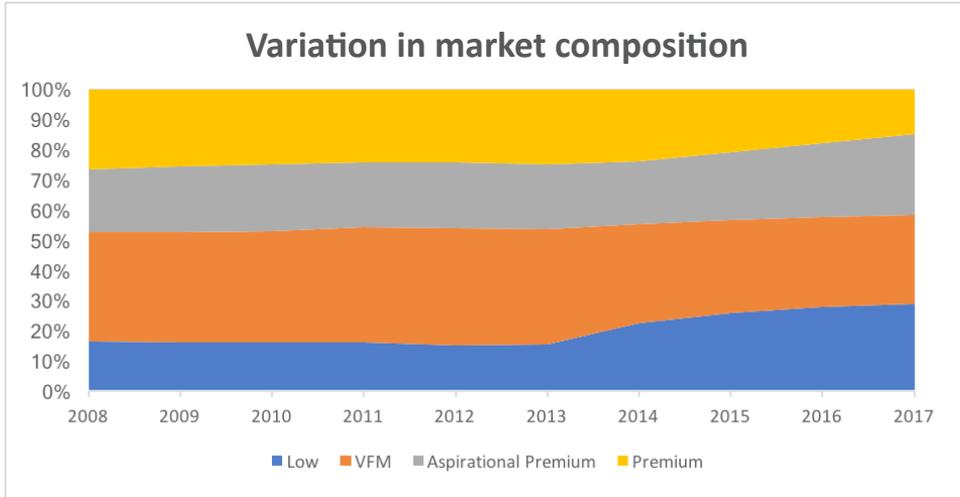
Tab. 7 - Percentage variation compared to the previous year.

	Volume	Excise duty	Average price
2009	-3.1%	0.8%	3.1%
2010	-2.4%	0.7%	1.6%
2011	-1.8%	2.8%	1.4%
2012	-7.9%	-2.5%	2.8%
2013	-6.0%	-5.4%	-0.7%
2014	0.5%	0.2%	-1.5%
2015	-0.8%	2.9%	3.3%
2016	-2.4%	-0.9%	2.0%

Source: CASMEF studies based on Nielsen and AAMS data.

The 2015 reform largely influenced the market structure in terms of segmentation, within the subdivision between high-band and low-band products. Figure 12 shows the dynamics of the shares according to price segment, *Low*, *Value for Money* (VFM), *Aspirational Premium* and *Premium*. As stressed in Section 1, the Italian market appears to be characterised by two independent groups of products, within which there are subgroups which over time have replaced each other. This is the so-called downtrading phenomenon, i.e. the “descent” of the consumer to the lower segment due to a general increase in prices or reduction in affordability of the products. This phenomenon was already visible from 2014 between the low-band segments, *Value for Money* and *Low*, with the latter increasing its market share to the detriment of the former. From 2015 the same phenomenon was even more obvious between the high-band segments, *Aspirational Premium* and *Premium*, with a steady migration of Premium consumers to *Aspirational Premium*. However, the shares of the two aggregated price bands (as defined in Section 1) do not seem to have changed significantly.

Fig. 12 - Trend of market shares according to price segment.



Source: CASMEF studies based on Nielsen data.

Moreover, the reform does not appear to have affected the trend of the fine-cut tobacco market. Table 8 shows the fine-cut market share, considering the equivalent cigarettes that can be produced with one gram of fine cut (as already mentioned, by convention this is 1.25): the market share grew very rapidly between 2010 and 2012, and then settled on a more moderate and stable trend.

The reform does not appear to have led to significant effects on the long-term trend of this product category.

Tab. 8 - Market share of fine-cut tobacco.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
1,5%	1,9%	2,5%	3,8%	5,8%	6,1%	6,2%	6,5%	6,9%	7,4%

Source: CASMEF studies based on Nielsen data.

Section 4: Level of compliance with requirements

In this sector, as it is a tax monopoly, there is full compliance with the legal market requirements due to the high level of controls and standardised procedures. The call for more extensive monitoring of each stage of management of the product also shows the need to counteract as efficiently as possible the so-called duty-not-paid and contraband.

Focus: The illegal market

Cigarettes are certainly among the most commonly sold products on the black market due to high profit margins, relative ease of manufacture and movement, and low risks and penalties. Cigarette smuggling has now become such a widespread phenomenon which, unsurprisingly, is also growing due to the frequent and easy circulation of goods and people. It is estimated that about 9% of the total European consumption is of illegal origin and that the resulting loss of revenue was €10.2 billion in 2016¹⁴. Note that this figure corresponds approximately to the total revenue from excise duty on cigarettes in Italy.

Illicit conduct mainly comprises contraband and counterfeiting. In Italy, the incidence of the illicit flow as a whole (contraband and counterfeiting) is equivalent to 5.8% of total consumption and has been basically stable since 2014. It is well under the European aver-

¹⁴ The data in this sub-section have been taken from the study: "Project SUN. A study of the illicit cigarette market in the European Union, Norway and Switzerland" produced by KPMG for 2016.

age (for example in Greece the proportion of the illicit trade is 19% of total consumption, and in a northern country such as the UK it is 14.3%). Counterfeiting is instead declining considerably and is really marginal (little over 4%) compared with the real problem of contraband of illicit cigarettes.

Contraband comprises two main categories: on the one hand, the so-called “illicit whites” (in 2016 these formed approximately 64% of illicit cigarettes), i.e. cigarettes manufactured legally in a country but smuggled during their movement to the destination country, and therefore sold without the relevant taxes being paid, and, on the other hand, known brands (the remaining 36%) i.e. cigarette brands which can also be found on the legal market but sold illegally.

Although Italy has quite a variety of inflow routes, in terms of distribution the phenomenon is particularly concentrated in certain areas of the country and especially in the south. The most affected cities are Naples (where 28% of the total packets are illicit), Palermo (12%), Giugliano in Campania (province of Naples, 10%) and Salerno (over 6%). In the north, on the east side, Trieste comes first (4.4%) while in the west it is Milan (2.1%)¹⁵.

Nevertheless, Italy is still the third market in Europe for consumption of illicit whites, and the best-known brands on the illegal Italian market include *Minsk*, *NZ*, *Regina*, *Yesmoke* and *Pine*. The various sources available on cigarette contraband (seizures by Fiscal Police, analyses provided by Project SUN and figures obtained

15 *L'Italia del contrabbando di sigarette. Le rotte, i punti di transito e i luoghi di consumo [Cigarette smuggling in Italy. Routes, transit points and consumption locations]*, by Andrea di Nicola and Giuseppe Espa, Intellegit – Università di Trento – Report 2017.

from Mystery Shopper activities, i.e. *incognito* shopping) show that Belarus is the largest source of procurement for criminal organisations of contraband cigarettes sold in Italy¹⁶. There are many routes by which they reach Italy, often overland across the border with Slovenia and the Brenner pass, or by sea from the Baltic ports or Greece. The main cause of these flows is the price differential compared with Italy: the cost of a packet of cigarettes in Belarus is about 60 cents, whereas the weighted average price of an Italian packet of cigarettes is 4.76 euros.

If this illegal consumption were converted to legal consumption, the revenue received by the Italian Treasury would increase by more than 800 million euros.

Section 5: Critical points

The main critical points of the current regulatory context are in the level of transparency of tax interventions. The legislation does not specifically clarify the extent of discretionary power that the Tobacco Commissioner (AAMS) may hold. While Legislators grant the Agency (AAMS) the power to put forward changes to the basic proportion, the fixed proportion and the minimum tax burden to the extent as set out above, they fail to define with equal clarity the following:

- **The sign of the changes.** It is not clear whether interventions on excise duty parameters should necessarily involve an increase or a

¹⁶ Same as 15.

reduction; also, it is not clear whether the reduction of one parameter can be linked to the increase of another.

- **Time limits.** The period to which legislators refer when establishing the limits of interventions is partly ambiguous: in particular, once a discretionary intervention has been carried out, it is not clear whether or not it can be repeated several times in the same year or if it affects the extent of subsequent interventions.
- **The limits of a single intervention.** The changes indicated represent the maximum extent of the discretionary power, but it is not clear whether they are absolute maximum levels or only maximum limits for increments relating to a defined time period. In the case of two or more consecutive discretionary changes, the problem arises as to whether the limits set by legislators should be understood as total or as referring to an individual intervention.

In order to guide and stabilise expectations of operators and, on final analysis, of demand, the Legislator could consider it advisable to clarify the ambiguities that are present in the reform, especially if the intervention limits have to refer to:

- an individual measure in the years after 2015, without, de facto, placing limits on the possibilities of change;
- an individual year, so not to be exceeded by the total provisions issued in each year;
- the entire period after 2015, thus constituting a certain and assumed limit on the extent of the changes, so once this limit has been reached, a new intervention by legislators is required.

However, more generally, the truly critical aspect lies in the correct identification of the presuppositions for the implementation of discretionary interventions by the Tobacco Commissioner (AAMS). To limit uncertainty in the decision-making processes of operators, it would therefore

be appropriate first to identify the conditions under which the Agency is allowed to change the structure of excise duties. The problem is of considerable practical significance as the three parameters on which the discretionary power of the AAMS is applied are actually independent. Obviously to change one parameter and leave the others unchanged could lead to non-neutral effects from the point of view of competition, as the three parameters affect the various product categories differently.

The long-term sustainability of the sector requires some clarification by Legislator with regard to the above-mentioned points, as the profitability of individual operators, and on final analysis the revenue, depend heavily on the competition dynamics that have hitherto developed in the market. The possibility that this regulatory framework could be changed in a discretionary and nonneutral manner places operators in a position of uncertainty which would be relatively simple to reduce, with benefits for the whole sector and the Treasury.

It would also be appropriate to show a direct link between the elasticity of demand to price and the interventions that operators should expect from legislators. Any consideration on revenue expectations cannot exclude market reactions to price adjustments brought about by a change in excise duty. From the economic perspective, an assessment of the demand is crucial for a plausible forecast of the behaviour of operators and the tax revenue they generate.

Section 6: Summary of the RIA and Conclusions

The reform appears to be consistent with the aims expressed in the relevant EU directive. Furthermore, various public interests have been well moderated: at least in principle, correct competition dynamics have

been ensured and the level of revenue has been protected, even as consumption decreases. From a strictly industrial perspective, in the first two years of implementation the reform had positive effects: concentration decreased, so did fragmentation; in addition, the reform encouraged a sufficiently wide price differential between the different product categories, preventing mass downtrading towards other forms of consumption with a lower tax contribution, for example fine-cut tobacco or even illegal products.

The costs generated by the reform appear acceptable, with regards to both direct costs for consumers generated by the increased tax burden, and indirect costs relating to the improvement in product management procedures.

By referring to the weighted average price, the reform has linked excise duty trend to market dynamics. By referring to traceability procedures, legislators have set up the conditions for improving monitoring of the market. The presuppositions have been created for having revenue expectations that are more in line with the market trend, rendering less likely interventions that could cause unsustainable structural shocks on the market.

Within the limits imposed by the short time since the reform, the reform appears to have already had positive effects, in particular on competition. The volume dynamics appear to be less linked to revenue dynamics, which suggests that the balance achieved in terms of distribution of the tax burden on the different product categories should be maintained to advantage, even if there are future increases in the tax incidence.

However, the reform is not without major critical points: in particular the discretionary power granted to the Tobacco Commissioner (AAMS) immediately proved to be poorly defined. If, in the first two years of implementation of the reform, the Tobacco Commissioner's interventions did not reveal the disruptive potential of this vague and far-reaching discre-

tional power, the intervention introduced in 2017¹⁷ was another matter: the Ministry increased the tax burden on cigarettes by raising the basic proportion, from 58.7% to 59.1%, increasing the specific component by half a percentage point to 10.5%, and increasing the minimum collectible tax to €175.54/kg.

This intervention brought an overall toughening of the tax burden for products of the lower price segments, in particular those subject to the minimum collectible tax; in fact, the increase in the basic component and specific component led to an average increase in fixed tax of about €1.01/kg on products not subject to the minimum collectible tax (i.e. medium-high price), which should have led to a similar increase in the minimum tax burden. Instead the actual increase in the minimum collectible tax was about five times the average increase of the specific component.

Such an intervention, increasing the tax incidence on low-price products, does not appear to fulfil the original aims of the reform, which should have led to a balanced and sustainable increase in the tax burden, without discretion and in a spirit of fairness.

The recent Decree, therefore, does not appear to have taken account of the reaction of demand to price adjustments resulting from tax increases: as market elasticity is greater than one, the transposition onto consumers of the greater tax burden, in particular on the cheaper products, could lead the market to shrink considerably and push consumers to depart from the legal market.

17 Decree of the Minister of Finance of 13th June 2017

FOCUS: towards an excise calendar?

The German case

The 2015 reform has generated a system whereby the tax burden is distributed in a balanced way, according to an approach which has proved to be fully compatible with a balanced development of the market. It is to be hoped that the adjustments to the structure of excise duty that will become necessary over the next few years will not only maintain a balanced distribution of the burden, but will be as gradual and planned as possible. This would enable operators to follow as correct as possible medium-long term prospects.

The German experience could be of great help in understanding the benefits of medium-long term planning of the tax parameters trend.

Between 2002 and 2005 the German government decided to quickly and significantly increase taxation on cigarettes to cover budget requirements that had arisen. Excise duty (entirely fixed in the German system) increased by 71% over four years, reaching an incidence of 62.3% of the average price. Due to the higher tax burden, over the same period the average price per packet of 20 increased by 51%. As a result, demand fell between 2002 and 2005 by almost one third of the market (data supplied by the local distributor). The overall reduction in market demand was accompanied by a clear shift in consumer direction towards low-price products (including fine cut) and a strong growth in contraband, resulting in a reduced revenue which remained below

expected values. Table 9 shows the difference between revenue forecasts and actual revenue, always clearly negative.

Tab. 9 - Difference between revenue forecasts and actual revenues.

	2003	2004	2005	2006
Difference between expected and actual revenue (billion euros)	-0.5	-2.3	-2.4	-0.3
DNP (billion cigarettes)	13.9	15.4	16.4	22.5

Sources: Ergebnis der 151. Sitzung des Arbeitskreises “Steuerschätzungen” vom 9. bis 11. Mai 2017 in Bad Muskau (Result of the 151st meeting of the working group on Tax Assessment from 9 to 11 May 2017 in Bad Muskau). Project SUN 2016 – KPMG.

It should be pointed out that, during the years of significant decline of the legal market (and hence instability of revenue), the contraband sector instead prospered. Demand, which turned to unofficial channels, increased from 10% of the volume of the legal market in 2003 to 24% in 2006.

Noting that a regulatory approach based on large and closely-spaced increases in excise duty did not lead to a stable market balance, and as the revenue objectives were not reached in any of the years in which the excise duty was increased, the German government changed strategy and indicated that the priority was to counteract the illicit trade.

The criterion that inspired the new approach was to ensure a sufficient increase in revenue, by the predictability and transparency of taxation objectives so as to reduce uncertainty for market operators. On the basis of these principles, in 2010 the introduction of a valid model was proposed for the following five

years, whereby the increase in excise duty would be constant and at least partly linked to the average inflation rate calculated over ten years. The increases would be effective from 1st January of each year.

The main result of this plan for the German government was the excellent response in terms of revenue. The 2011-2015 plan even led to a total revenue that exceeded forecasts (which were nevertheless increasing compared with previous years). As shown in Table 10, in the first year of implementation of the new strategy, actual revenue exceeded the expected value by one billion euros. This also happened in the following years, although with smaller differences except for 2013 when the revenue was basically in line with expectations. Overall, during the years when the reform was implemented the revenue result exceeded expectations by 2.4 billion euros.

Tab. 10 - Difference between revenue forecasts and volumes of the illicit market

	2011	2012	2013	2014	2015
Difference between expected and actual revenue (billion euros)	1	0.4	-0.1	0.5	0.6
DNP (billion cigarettes)	21.6	19.4	17.4	16.3	15.2

Sources: Ergebnis der 151. Sitzung des Arbeitskreises “Steuerschätzungen” vom 9. bis 11. Mai 2017 in Bad Muskau (Result of the 151st meeting of the working group on Tax Assessment from 9 to 11 May 2017 in Bad Muskau). Project SUN 2016 – KPMG.

At the same time, the action against contraband was effec-

tive. The phenomenon decreased in terms of volume (from 21.6 to 15.2 billion cigarettes), and in terms of incidence on the legal market, decreasing from 23% in 2011 to 19% in 2015.

The strength of the German model was that it introduced gradual and moderate increases in excise duty, in line with the general price trend. The gradual introduction of the excise duty interventions reduced the trend towards consumption of low-price products and the risk of a further expansion of the illegal market, avoiding a decline in revenue. A further benefit of this approach is that less activity is required from the Administration each year: as the excise duty is predetermined for five years, during the years after the first year, the Administration can allocate its resources to all the other matters on the tax agenda.

In conclusion, and in the light of the most successful European experiences, in Italy it would be advisable to proceed in accordance with guidelines closer to the initial spirit of Decree 188/2014 in order to seek balanced growth of the tobacco market. As happened in Germany, to ensure the predictability and gradual nature of interventions would contribute significantly to achieving both revenue and health protection objectives.

It should also be pointed out that corrective interventions of this kind can generate positive effects on the competitiveness of the entire economic system. Certainly, the strongest points of the German economic and manufacturing system include the remarkable tendency to attract foreign investments. In the peculiar classification of places most open to ease of business, Italy continues to be behind (although its position is improving). As clearly shown by a recent research study conducted by Confind-

ustria¹⁸; Italy holds 45th position in the world ranking for the ability to attract and sustain medium-long term direct investments from the large multinationals.

Italy's reputation and efficiency are penalised by only a few but very noticeable limitations: first of all, the unpredictability and discretionary nature of administrative justice, considered to be too slow; an innovative ecosystem that is still too fragile; an employment market that has remained sclerotic for decades and is only now starting to be more dynamic; but above all the lack of certainty of the law and inadequate tax planning.

Certainty of law and taxation are two strong structural elements in the global competition game. The complex mechanism of tobacco taxation should therefore not be an exception as, let it be remembered, in nearly all OECD countries it contributes to large proportions – often over 50% – of public finance balances and the respective budget actions.

The German government did not intend to give the market players – who, let it be repeated, are nearly everywhere concentrated in few primary actors, all multinational in nature and structure – any “preferential treatment”. Rather, over the last 10 years taxation has become inexorably tougher, although this has happened in an ordered and predictable way, and is directly linked to objective parameters – in the case in question, the inflation rate plus an increase. This has enabled all the actors in the system to benefit: the Treasury by a systematic increase in its revenue; companies by planning large investments and calculat-

18 *Investire in Italia: quadro normativo ed istituzionale per gli investimenti esteri* [Investing in Italy: regulatory and institutional framework for foreign investments], Rome 13 June 2017

ing costs and strategies in advance; and consumers by not being faced with sudden price shocks, as tobacco price increases are also linked to the economic cycle.

In conclusion, an excise calendar could therefore be the preferred instrument for ensuring an orderly change to a system that is extremely delicate in its set-up and balances, and within which predictability is an asset to be strengthened in countries such as Italy, where too much discretionary power risks encouraging an uncertainty that is too onerous and costly for the entire system.

REGULATORY
IMPACT
ASSESSMENT:
GREECE

The current cigarette taxation system in Greece is heavily unbalanced towards the specific component which totals €82.5/kg, compared with a *ad valorem* (proportional) component in proportion to value equal to 20% of the final sale price. At the same time, the minimum collectible excise (MCE) is €117.50/kg¹⁹.

The current scenario is not representative of the history of the sector in Greece, and should rather be considered as the result of a recently-issued taxation reform which came into force in November 2012. In fact, at the

¹⁹ Data updated on December 2016.

beginning of 2010 the system was still heavily unbalanced towards the *ad valorem* (proportional) component, equal to 53.83% of the final sale price, with a fixed excise duty of only €5.88/kg and an MCE of €73.60/kg.

Table 11 gives in chronological order the changes in the taxation parameters: it may be observed that, although with frequent adjustments which increased both the specific component and the minimum excise, the system maintained its highly proportional nature up until October 2012. In November 2012, the specific component virtually quadrupled to €80/kg, the proportional component was reduced to 20% of the sale price and the MCE was increased to €115/kg. The initial parameters of the reform were then adjusted from January 2014 and remained unchanged until December 2016.

Compared with the 2015 Italian reform, it should be mentioned that the innovations contained in the 2012 Greek reform were not accompanied by measures on aspects of the sector other than those relating only to taxation.

Tab. 11 - Summary of the recent changes to the cigarette taxation structure in Greece.

	Apr-10	Jun-10	Jan-11	Jul-11	Feb-12	Nov-12	Jan-14	Jun-16
Ad Valorem (Proportional)	58.82%	58.43%	52.45%	52.45%	52.45%	20.00%	20.00%	20.00%
Specific per mille	9.88	13.71	19.66	19.66	20.37	80.00	82.50	82.50
Minimum excise (MCE)	78.00	80.40	76.32	101.76	105.48	115.00	117.50	117.50
VAT	21.00%	23.00%	23.00%	23.00%	23.00%	23.00%	23.00%	24.00%

Source: CASMEF studies on Greek Ministry of Finance.

Section 1: Achieving the goals

The 2012 reform had a strong impact on the equilibrium of the cigarette sector in Greece. However, it did not present specific aims with regards to the subsequent industrial impact. The contingent need met by the measure was purely to do with revenue, and arose in the context of major clear-cut transformations of the Greek economy following the acquisition of its public debt by the international *Troika* comprising the European Central Bank, the International Monetary Fund and the European Union. Since 2010, it was obviously necessary to significantly increase the revenue generated by the tobacco sector, which had been falling sharply in the preceding years.

The measures implemented by the Greek Legislator, however, did not include any specific reference to the development of the sector, not even in the terms of Directive 2011/64/EU, which is the reference framework for national taxation of tobacco products. In particular, the Directive states that the public interest must involve both protection of health and competitiveness of the sector, although it is difficult to reconcile the presumed taxation intention of the reform with protecting competition.

The increase in the specific component in itself has a significantly higher impact on products with a low sale price, while a reduction in the proportional component benefits high-price products. Therefore, accompanying a 300% increase in the specific component with halving of the *ad valorem* (proportional) component can only lead to unequal effects on products of different prices. The two measures move in the same direction, causing price increases only for products in the lower price segments: the higher tax incidence is distributed unequally, constituting an increase for only some operators and distorting the competition.

The measure was focused on the need to increase, or at least stabilise,

tax revenue. However, even when excluding the expected impact on the level of competition, the current reform did not take into account the predictable reaction of demand to an increase in the prices of the most affordable products for consumers. The destabilising effects were magnified by the fact that the new tax system was not implemented gradually: the market operators made a sudden increase from a specific component of €20.37/kg to €80/kg, with no gradual rise to that value. This resulted in sudden price changes for the low-price products, which were a shock to consumers.

When it comes to assessing the achievement of the goals of the measure in force since 2012, in the absence of specifically stated goals, the analysis has to be limited to the aims imposed by Directive 2011/64/EU, i.e. reduction of market fragmentation and reduction in concentration.

Table 12 gives the market shares between 2010 and 2016, *in tandem* with the transition to an excise duty that is more unbalanced towards the specific component: the number of segments increases from 2012, when the prices changed in such a way as to create a new price band, the *Aspirational Premium*, which combined products from the higher categories. For some high-segments products, it was possible to reduce the prices, as shown in Table 13²⁰, as they were favoured by the new taxation structure. It should be noted that already in 2010 the sum of the *Low* and *Value For Money* segments consisted almost entirely of *Low* segment products, while the increase in the specific component actually cancelled the price differences within this aggregated segment.

20 In Table 13, to show the price trend, the price bands for 2016 are used and therefore the *Aspirational Premium* segment appears in years before 2012. Thus, the price dynamics in each segment can be followed, taking into account the products contained in it at the end of 2016.

**THE FISCAL REFORMS OF TOBACCO MARKET IN ITALY AND GREECE:
TOWARDS AN EXCISE CALENDAR**

Tab. 12 - Cigarette market, market shares.

	2010	2013	2016
VFM - LOW	57.4%	52.3%	49.5%
ASPIRATIONAL PREMIUM	-	14.7%	15.0%
PREMIUM	42.6%	33.0%	35.5%

Source: CASMEF studies based on Nielsen data.

The market segment with the lowest prices (*Low* and *Value For Money*) lost about 8 percentage points between 2010 and 2016, redistributed more or less equally between the higher segments. The *Aspirational Premium* segment now has a stable market share of around 15%, while the *Premium* segment appears to have shrunk by about 10 percentage points. However, as the *Aspirational Premium* segment consists of some products from *Premium*, it may be concluded that the market tended towards medium- and high-band products more than in the past.

Tab. 13 - Average prices per segment. Deflated values.

	2010	2011	2012	2013	2014	2015	2016
VFM - LOW	2.56	2.72	2.75	2.86	3.27	3.48	3.49
ASPIRATIONAL PREMIUM	3.50	3.52	3.30	3.27	3.52	3.68	3.70
PREMIUM	3.48	3.46	2.91	2.73	3.71	4.01	4.03
MARKET	2.97	3.03	2.87	2.88	3.46	3.69	3.71

Source: CASMEF studies based on Nielsen data.

The trend in market shares after the reform is in line with what may be expected from a large increase in the specific component, as the new tax burden ended up by having a greater incidence on lower-price products, which became less attractive. As shown in Table 13, the macro-segment consisting of the combined *Value For Money* and *Low* is the one that sustained the largest price increase.

The trend in market shares and the emergence of a new price segment rendered the market more fragmented than during the period before the reform. This result conflicts with the aims of Directive 2011/64/EU and is therefore a critical aspect of the reform.

Tab. 14 - Theoretical average growth rates had the growth been constant every year.

	Average growth rate 2010-2016
VFM - LOW	5.3%
ASPIRATIONAL PREMIUM	0.9%
PREMIUM	2.5%
MARKET	3.8%

Source: CASMEF studies based on Nielsen data.

Table 15 shows the market shares of the individual manufacturers operating on the Greek market: among the local manufacturers, only Karelia increased its market share, from 9.7% in 2010 to 15.1% in 2016, and only Sekap maintained a significant market share in 2016, although half that of 2010.

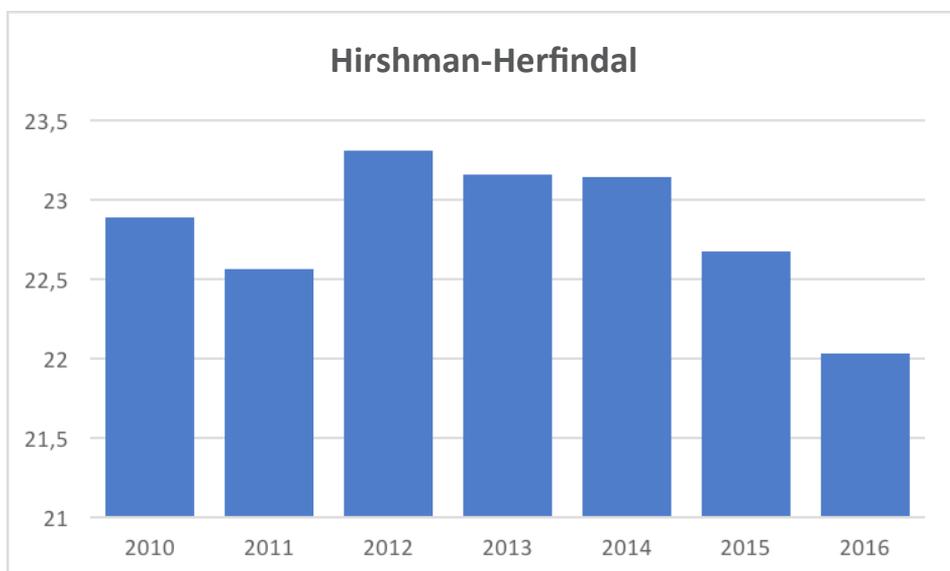
Tab. 15 - Market shares of the main operators.

	2010	2016
BAT	17.2%	15.4%
GEORGIADES	0.2%	0.0%
PHILIP MORRIS	38.5%	35.3%
JTI	14.7%	18.2%
KARELIA	9.7%	15.1%
IMPERIAL	11.2%	12.2%
IMPORTED	0.0%	0.0%
SEKAP	8.5%	3.9%

Source: CASMEF studies based on Nielsen data.

The trend of market shares of individual operators is uneven: among the major manufacturers, Philip Morris decreased its market share, so did BAT, while JTI and Imperial Tobacco increased theirs. This trend is generally confirmed by the *Hirschman-Herfindahl* (HH) index of market concentration, which since 2012 appears to be decreasing. The reduction in the HH index shows a lower market concentration. At this point, therefore, the reform appears to be in line with the aims of the European Directive.

Fig. 13 - *Hirschman-Herfindahl* concentration index. A higher value indicates a greater market concentration.



Source: CASMEF studies based on Nielsen data.

Table 16 shows the maximum and minimum market prices. The minimum price is the most representative price of the *Low* segment, while the maximum price is the most representative price of the *Premium* segment. The difference between the maximum and minimum prices (price gap) is an indicator of the size of the product range present on the market, and is therefore indicative of the consumption opportunities available to the public. As may be observed, there is a change from a price gap of 60

cents for a 20-sticks pack to a differential of 30 cents: this halving is the result of the dynamics set in motion by the reform, as the increase in the minimum price was more than double (in nominal terms) that of the maximum price.

Tab. 16 - Prices per 20 sticks pack between the product most sold in the *Low* and *Premium* segments.

	2010	2016
MIN	3.20	3.90
MAX	3.80	4.20

Source: CASMEF studies based on Nielsen data.

Section 2: Costs assessment

The main cost generated by the reform of excise duty on cigarettes consists of the higher taxation on the products in the lower price segments.

Between 2012 and 2013, the incidence of excise duty on the average price (€145/kg) increased from 68.5% to 77.4%. With regards to the most representative price of the *Low* segment (€165/kg in 2012 and 2013), the incidence increased from 64.4% to 69.7%, while the incidence on the highest price (€190/kg) decreased from 62.8% to 62.1%.

In the two years 2012-2013 many typically *Premium* products were sold at lower prices than typically *Low* products, confirming a turbulent phase in the market and an obvious “price war” in progress. Therefore, while retaining the same classification according to segments prior to the reform, the average market price was even lower than the average price

for the *Low* segment.

Comparing the market situation generated by the previous excise system with the situation generated by the reform and analysing both the average market price and the taxation at the end of 2010 and the end of 2016, it may be observed (Table 17) that the incidence of the average price decreased from 67.7% to 64.5% due to the significant price increases occurring during 2013. The reduction is all the more marked the higher the price considered.

Tab. 17 - Incidence of excise duty on weighted average price.

	Dec-2010	Dec-2016
Weighted Average Price (WAP)	147.5	185.5
Ad valorem (proportional)	58.43%	20.00%
Specific per mille	13.71	82.50
MCE per mille	80.40	117.50
Nominal VAT	23.00%	24.00%
Actual VAT	18.70%	19.35%
Total taxation	99.9	119.6
Incidence of excise	67.7%	64.5%

Source: CASMEF studies on Nielsen data.

Table 18 shows affordability index for the years 2011 to 2016. A determining factor for calculating the index is the overall level of economic activity: its trend is strongly affected by the particularly difficult crisis experienced by Greece during the years of the analysis. It may be observed that the consumer continuously lost purchasing power up until 2015, and particularly so in 2011 and 2014; however, in 2011 most of the variation in the index was due to a drastic fall in gross domestic product (-9.1%) and resulting fall in average income (-11.5%). In 2014, the variation in the index may be attributed entirely to the increase in cigarette prices: in fact, the GDP in 2014 remained more or less stable (+0.3%) and with it income

(-0.2%), whereas the average price of cigarettes increased by 18.6%.

The trend of the affordability index, together with the considerations of the incidence trend, shows that the increase in tax burden was borne mainly by the consumer, for whom the product generally became more expensive as manufacturers were obliged to pass on the heavy tax burden (with the price range not widening at the same time).

Tab. 18 - Affordability index. Percentage variation of the ratio between the average price of cigarettes and average employment income. An index value higher than zero indicates a loss of purchasing power on the cigarette market.

	2011	2012	2013	2014	2015	2016
Affordability	22,3%	9,2%	10,4%	19,9%	7,0%	-3,0%

Source: CASMEF studies on Nielsen and Eurostat data.

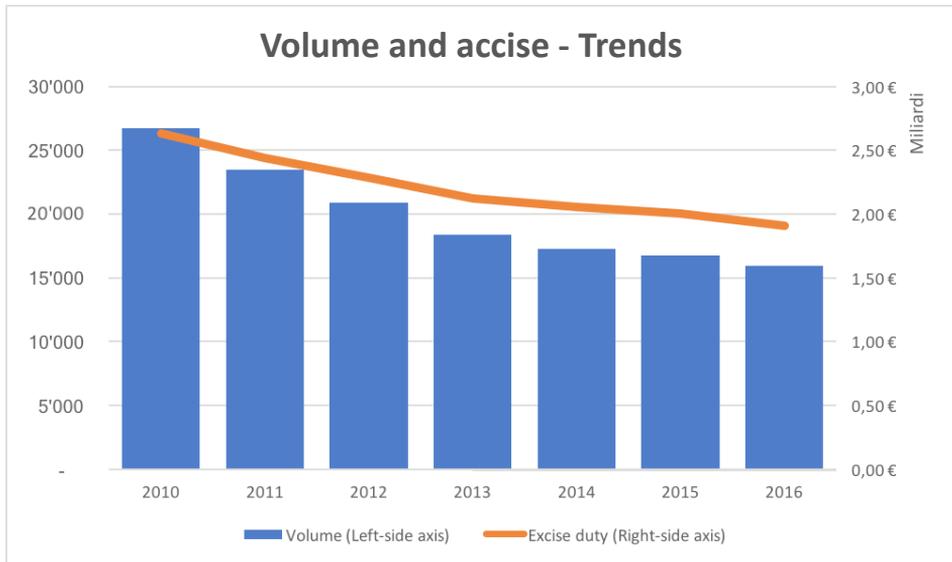
The general increase in taxation which occurred in 2012, implemented suddenly, in fact prevented a gradual adjustment of the market in terms of both supply and demand conditions. The burden of the adjustment was absorbed almost entirely by consumers.

Section 3: Resulting effects

Figure 14 shows the trend of volumes and revenue from excise duty in Greece: in the period between 2010 and 2016 the market shrank by a total of 41%; between 2010 and 2012 it lost 22% of its size in terms of quantities traded, while between 2012 and 2016 the decline was 24%. If the fall in the three years 2010-2012 can be largely attributed to the severe aggravation of the Greek macroeconomic situation, with the GDP in those three years falling by 5.5%, 9.1% and 7.3% respectively, in the subsequent period the market trend was much more likely the result of internal dynamics. The GDP between 2012 and 2016 took a more stable path, although decreasing by 3% in 2013, with changes of between -0.2% and 0.35% in the subsequent years.

The reform did not lead to the desired effects on the trend of excise duty, which decreased continuously between 2010 and 2016 (Table 19).

Fig. 14 - Trend of market volumes (in thousand kg) and excise duty.



Source: CASMEF studies based on Nielsen data.

Even in the absence of considerations on the elasticity of demand in relation to price which, although appropriate, are outside the scope of this analysis, it is clear that the reform did not produce the expected effects in terms of revenue: the changes in average price (WAP) shown in Table 19 indicate that, despite the continuous increases, the revenue continued its descent and in 2015 the reduction was more than double in percentage terms than the year before. A comparison between the post-reform period (2013 to 2016) and the pre-reform period (2010-2012) cannot fail to consider the profound shock suffered by the Greek economy due to the government being unable to have recourse to the financial markets. The repercussion on aggregate demand was vast, as shown by the changes in GDP in the years mentioned in the above paragraphs. Between 2013 and 2016, the overall level of economic activity appears to have started stabilising, albeit with difficulty, and a trend towards stabilisation of the demand for cigarettes could be expected. However, the profound shock on prices brought about by the excise duty reform prolonged the fall in sales, without these showing any signs of stabilising: in 2016 the reduction in volume was even double (in percentage terms) compared with the previous year.

Tab. 19 - Year-on-year percentage variations in market volume, excise and average market price (WAP).

	Volume (var %)	Excise (var %)	WAP (var %)
2011	-12.1%	-7.2%	5.0%
2012	-11.1%	-6.4%	-4.3%
2013	-11.9%	-7.0%	-0.5%
2014	-6.4%	-3.3%	18.6%
2015	-2.6%	-2.2%	5.5%
2016	-5.2%	-5.1%	0.5%

Source: CASMEF studies on Nielsen data.

In view of the long-term trends and the absence of a product range with sufficient price differentiation (to meet, including by downtrading, the consumption requirements of the population bands most affected by the economic crisis), in the short term the market may well achieve volumes less than half of those of 2010. The current excise duty system does not permit price reductions for products in the lower segments and encourages further restriction of the differential between prevalent prices on the market (price gap), without this leading to an actual increase in volume, and consequently of revenue.

Section 4: Level of compliance with requirements

The signs emerging from the market in the years after the reform are alarming, and suggest that an increasing proportion of demand is gradually leaving the legal market.

The absence of a legal product at an affordable price, which would instead be possible with a wider price gap, appears to have generated a large increase in demand for products sold via unofficial channels (duty-not-paid – DNP), which renders the critical aspects of the market even more critical, encourages criminal organisations and greatly reduces consumer protection. According to a study conducted by KPMG²¹, in the period between 2012 and 2016 the proportion of DNP in Greece increased from 13.4% to 18.8%: almost one fifth of the market is managed outside official channels.

Together with revenue dynamics not in line with expectations, this suggests that there are structural shortfalls in the current regulations and

21 *“Project SUN. A study of the illicit cigarette market in the European Union, Norway and Switzerland – 2016 results”*. KPMG, 2017.

that a thorough revision would be appropriate. It is also useful to mention the increase in consumption of artisanal fine-cut tobacco, which escapes the control of local authorities.

Section 5: Critical points

The adjustment phase of the market after the reform of the excise structure appears to have set the Greek market on a course of marked decline and general impoverishment. The market's equilibrium appears to be heavily compromised and continuously shifting towards lower demand. The main consequence, in relation to the primary intention of the reform, is that revenue sustainability does not appear to be guaranteed in future years. The successive price increases have caused a continuous decline in demand and resulting reduction in revenue.

The main critical points of the new regulations are:

- **Excessive reduction in the price gap.** The price gap was reduced by higher price increases for the cheaper products. The range of legal products available to consumers became more limited and a significant proportion of demand departed from the market. This did not necessarily lead to a reduction in number of smokers: it is likely that many consumers migrated to illegal distribution outlets.
- **Lack of actions to counteract the illegal market.** The reform concentrated on the tax aspect, omitting the economic analysis of the impact that this would have had on the market. The growth of the illegal contraband cigarette market would have required greater attention in order to protect the population, counteract criminal organisations and support tax revenue. The efforts to directly counteract the distribution of illegal products require adequate inves-

tigative and operative support, the costs of which (at least partly generated by the reform) will be payable by the community.

- **Lack of reference to the elasticity of demand.** In a perspective focused on revenue, the elasticity of demand should have been considered as crucial, especially because it was brought about by a large and rapid increase in prices. Furthermore, this reform does not have any mechanism that can stabilise operators' expectations: in a highly unstable context such as that of the years after the reform, to be able to stabilise expectations by means of a predefined adjustment mechanism which is known to operators (preferably able to follow market trends) could have helped and could still help stabilise the market.
- **Lack of rationalisation of distribution.** There is formal liberalisation in place, and therefore about 100 distributors operate in Greece. However, the competitive dynamics are made tougher by the high geographical segmentation of distributors.

Section 6: Summary of the Regulatory Impact Assessment and Conclusions

The reform of the cigarette excise duty in Greece entered into force at the end of 2012 at a time of severe economic instability for the whole country. The reform increased the fixed excise duty from about €20 per thousand cigarettes to €80, and at the same time the proportional component linking the tax to the sale price was halved from about 52% to 20%. The excise burden was shifted significantly towards products sold at lower prices.

Most of the tax cost of the reform was borne by consumers, as the

total incidence (which is a measure of the cost for manufacturers), calculated on the new prices which the reform brought about, decreased.

The price variations caused by the new regulations were marked and rapid, especially in the low-price segment of the market. The price differential between high-band products and low-band products thus decreased, excluding a significant portion of the demand from the legal market.

The recent KPMG estimates²² indicate that the percentage of *Duty-Not-Paid* in the country increased from 13.4% to 18.8% of the market. The costs of counteracting illicit activities relating to tobacco are likely to be repeated among the future costs generated by the reform.

On a general level, the reform did not lead to the results expected at the time of its entry into force: the market appears unstable and further intervention on the entire sector appears inevitable to prevent its collapse. Any further reflections should concentrate on the economic sustainability of the changes, including detailed analyses on the expected reactions of demand and operators. Any partial adjustments aimed at marginally increasing the proportional component may not be enough to stabilise the market, which at the moment still appears to be undergoing major transformation.

The reform, concentrated on the short-term tax aspect, albeit drastic and sudden, also appears to be a missed opportunity to rationalise distribution and retail sales.

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CONCLUSIONS

- Two years after the introduction of the excise reform, the Italian tobacco market appeared to be well on the way to balanced stability.
 - The dynamics in progress in 2015-2016 were in line with the public health objectives, with a stable percentage of smokers at historically low values, and market volumes gradually decreasing, in accordance with a confirmed trend in industrialised economies.
 - The revenue trend was basically stable and in line with the market trend: in particular, after the sharp decline in 2012-

2013, tax revenue showed a less volatile trend.

- The comparison with the impact of the Greek reform shows that the balanced choices made in Italy enabled the tax burden to become tougher without, however, distorting competition on the market. In Italy consumers were still able to access a wide and diversified range of products. In contrast, the 2012 Greek reform led to an upset in the excise system, which from predominantly proportional became predominantly specific: this led to a higher tax burden on the low-price products, depriving consumers of cheaper alternatives. The Greek market has not yet stabilised: volumes and revenue continued to decline in the years after the reform and the turnover of the illegal market has grown exponentially.
- To ensure the long-term stability of revenue, it is necessary to guarantee to the market operators predictable and transparent tax and regulatory policies. In Italy (contrary to what happened in Greece), the 2015 reform rightly included a mechanism for linking the tax parameters to the weighted average price. However, it also introduced elements of discretionary power for the Public Administration, which rendered the medium- and long-term horizon very uncertain for the operators. This discretionary power, apart from subjecting the Administration to pressure from market operators, jeopardises revenue stability.
- For example, the first months of 2017 were characterised by considerable uncertainty, which led to delays in adapting the parameters and consequently a loss of revenue. Among other things, due to the worrying state of the public accounts, decisions on tobacco taxation (discretionary and only vaguely prompted by legal presuppositions) were taken under urgent conditions and as a result were very unbalanced, as already mentioned.

THE FISCAL REFORMS OF TOBACCO MARKET IN ITALY AND GREECE: TOWARDS AN EXCISE CALENDAR

- It is clearly necessary to plan interventions that permit a stabilisation of the expectations of both the market operators (manufacturers, distributors and sellers) and the Treasury.
- It would therefore appear desirable to have a shared and definite medium-term plan (e.g. five years), in order to stabilise operators' expectations and reduce margins of uncertainty. While observing the keystone principles of tobacco tax legislation, it would be appropriate to draw up certain rules for the development of reference parameters at least in the medium term.
- The Greek case shows that these rules should aim towards a gradual transition towards a tax system predominantly based on the fixed excise component, while respecting the balance of market competition which, once disrupted, is difficult to re-establish and leads to serious harm to revenue as well.
- The challenge now is to redesign the Italian tax system on fine-cut tobacco by acknowledging the positive aspects of current legislation and correcting the errors made, bearing in mind the experiences in other European countries. The basic idea should be to reduce all kinds of discretionary power and find common ground between different requirements in order to reach shared objectives: revenue, competition and health. In this respect, a negative example is certainly Greece, but also countries in which the push towards indiscriminate toughening of tax pressure has left room for an exponential increase in the illegal trade (such as in the United Kingdom).
- For many years, including recent years, Italy has been a unique virtuous example to be followed, and can continue to be so provided the right corrections are made to the current system, also by partly copying the solutions found in other countries such as Germany.
- The study refers to the German experience which included the in-

troduction of a planned and predictable model for updating tax parameters. This system has made it possible to achieve objectives in terms of both revenue and counteracting contraband, showing that planning a medium-long term tax calendar has positive effects not only on market sustainability but also on achieving public health aims.

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The Study describes the current situation of the tobacco Italian market two years after the 2015 Fiscal Reform has entered into force.

The effects of the reform are analysed through a structured Regulatory Impact Assessment (RIA): this tool - set by the Italian legislation but only rarely carried out – includes some formal steps aimed at identifying the strengths as well as the weaknesses of a recently applied regulatory set.

This rigorous methodology has been applied to analyse the effects of the above mentioned 2015 Italian Fiscal Reform as well as to the Greek Fiscal Reform which was introduced in 2012: the objective was to point out both positive and negative aspects of the Italian model through a comparison with the Greek case.

A set of guidelines for the next future is the main result of this Study: besides figures, such guidelines call for more transparency and predictability of fiscal policies in the tobacco sector as to ensure both sustainability of the market and future revenues.

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