

Differentiated taxation aimed at
reducing risks from products with
harmful externalities



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Prepared by

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Philip Morris Bulgaria EOOD commissioned Ernst & Young to prepare this report for the purpose of providing expert analysis on tobacco products taxation aimed at tobacco harm reduction.

The content, selection of themes and products with harmful externalities for the analysis and the conclusions are developed and are the sole result of Ernst & Young experts' work. The views and opinions expressed in this document are those of Ernst & Young and do not necessarily reflect the views of Philip Morris Bulgaria EOOD.

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Abbreviations

Alcohol Rates Directive	Directive (EU) 2020/1151 of 29 July 2020 amending Directive 92/83/EEC on the harmonization of the structures of excise duties on alcohol and alcoholic beverages
Alcohol Structure Directive	Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages
CN	Combined Nomenclature
ETD/Energy Taxation Directive	Council Directive 2003/96/EC of 23 October 2003 restructuring the Community framework for the taxation of energy products and electricity
EDTWA	Excise Duties and Tax Warehouses Act
EGD	European Green Deal
EU	European union
EMCS	Excise Movement and Control System
FDA	Food and Drug Administration
FCTC	Framework Convention on Tobacco Control
GAP	Global Action Plan on Noncommunicable Diseases
HTPs	Heated Tobacco Products
NCAs	Non-Combustible Alternatives
NCD	Noncommunicable disease

Tobacco Excise Directive

Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco

SSBs

Sugar-sweetened beverages

VAT

Value Added Tax

WHO

World Health Organization



Introduction

Introduction

The goal most often associated with taxation policies is collection of revenues. Historically, one of the means for such collection has been the imposition of taxes on "luxury" items / activities or ones which are deemed to be harmful for the individual and the society. Some examples include levies on gambling, coffee, tea, alcohol, and tobacco. During the last decades, the logic behind such taxes has been complemented by new aims. These novel goals include policies concerning improvement of public health and environmental sustainability. Among the reasons for this shift is the development of the field of behavioral economics and its impact on tax policies.

I. Behavioral economics and taxation

Behavioral economics is a combination of psychology and economics that researches markets where agents display human limitations and complications. The latter, for example, include specific perceptions determining behavioral responses of consumers. Going further, behavioral economics focuses on taxes which seek to achieve specific changes in human behavior, i.e., on corrective taxation.¹

The reason for such an approach is that the economic choices of households and enterprises often lead to market failure in the form of under or over-production of goods (from the point of view of maximizing the welfare of society as a whole). A market failure is technically defined as a sub-optimal allocation of resources. One of the means for correcting these market failures is encouraging behavioral changes via three main levers: regulation, pricing, and information. Specifically, taxes may be designed to correct market failures by shifting behaviors in a desired direction (e.g., by discouraging or encouraging certain behavioral response) thus acting as "corrective taxes"² given their role in goods' price formation. In other words, tax efficiency depends on how individuals respond to the levy and do or do not amend their attitudes.

Going forward, taxation is used as a solution to market failures caused by "externalities" and "internalities." An "externality" relates to an activity performed by one person or group that influences another person (group) without the latter being compensated for the negative results. An "internality" is the long-term benefit or cost to an individual or a group not considered when making the decision to consume goods or services. On such example are the internalities affecting people who continue with a high sugar diet.

In case of goods, these effects are usually not reflected in their prices unless an additional levy is imposed (e.g., harmful emissions from energy products and imposition of taxes on such emissions). The behavioral approach further recognizes the complexity behind the harmful externalities and specifically that human decisions arise from certain "internalities", in other words, internalities are externalities that individuals (consumers) impose on themselves.³

¹ "Implications of behavioural economics for tax policy", J. Acheson and Donal Lynch, Irish Government Economic and Evaluation Service, July 2017, p. 1 – 2.

² Ibid, at p. 5.

³ Ibid, at p. 20.

For example, smokers tend to place a higher value on current rewards from smoking (short-term gain) than on future health (long-term gain). This constitutes a positive time preference, namely, valuation of presumed present gains over future outcomes. Some research concerning tobacco consumption even consider the effect of "hyperbolic discounting" whereby the costs and benefits which consumers experience in the near future substantially outweigh those in the distant future, i.e., the presumed current "premium" is so high that it underrates all cumulative future harms.⁴

The reasons behind such deviations are twofold. First, in contrast with the logic adopted by general economic theories, individuals are imperfectly rational to the extent they are not always making the optimal choice. Second, individuals and firms may have non-standard preferences often inconsistent with the assumptions of standard economic models.⁵

The corrective taxes are based on specific assumptions such as:⁶

- The higher the sensitivity of demand to price, the greater the impact a tax will have in reducing consumption (taxes on goods whereby demand is insensitive to price will likely be ineffective at reducing consumption and vice versa)
- The higher the sensitivity of supply to price, the greater the impact a tax will have in reducing production (taxes on goods whereby supply is insensitive to price will likely be ineffective at reducing production and vice versa)
- The tax should be simple and directly target the harmful externality and internality
- The levy should be set in a manner considering the harmful impact including on third parties
- The approach should preferably be wider in scope (e.g., whole-of-system approach such as taxation coupled with provisions of incentives for investments, research and development of less harmful and cleaner or better alternatives).

Traits associated with corrective taxes include:⁷

- Salience - more salient tax measure will be more effective at changing behavior
- Bounded rationality - a less complex tax is more efficient than a complex one
- Loss aversion - levy perceived as a loss is more effective at molding behavior than one perceived as a forgone gain
- Time inconsistency - the closer the accrual of the tax to the taxed activity, the more efficient the tax is in terms of changing behavior.

An example for corrective taxation is correction of combusted tobacco consumption (smoking) resulting from excessive discounting of future costs. In this regard, higher prices provide self-control instrument which cannot be easily circumvented by producers and smokers. Such taxes, in practice, are analogous to correction of externality, but they also aim at correcting an

⁴ "A Behavioural Economics Perspective on Tobacco Taxation", Rajeev Cherukupalli, American Journal of Public Health, April 2010, Vol. 100, No 4, p. 610 – 612.

⁵ "Behavioural Economics and Tax Policy", William J. Congdon, Jeffrey R. Kling, and Sendhil Mullainathan, p. 4.

⁶ "Implications of behavioural economics for tax policy", p. 5.

⁷ Ibid, p. 24.

internality, a consequence on individual health that the smoker would not desire if the decision for smoking is made under less impatient circumstances.⁸

Another important aspect in relation to behavioral economics and its link with taxation policies is that the corrective taxes do not aim solely at collection of public revenues. Instead, taxes are also used as a source of income to finance publicly provided goods and services often related to the harmful good or activity. Examples include public health services linked to tackling diseases from alcohol abuse, financing of social security programs based on the principle of "solidarity", etc. Hence, corrective taxes are not exclusively evaluated through the raised revenue, but rather their broader impact on societal welfare, i.e., the success of the tax policy is assessed through the overall behavioral change towards cessation of usage or switching to alternatives with lower burden of harm (not simply in terms of revenue).⁹

The impact of corrective taxes may differ depending on the sphere and the targeted products / activities as their imposition may run contrary to other economic or social goals. For example, increased taxation of energy products may not only run contrary to the economic interests of specific sectors and industries, but also lead to undesirable overall economic effect through increased inflation and higher prices for final consumers. Similar negative accompanying effects may be resulting from imposition of taxes on food and beverages. Furthermore, while alcohol and tobacco consumption may appear an area where imposition of increased taxes are proper means to achieve health effects, sharp tax increases may contribute to development of illegal markets thus mitigating or even reversing the positive effects. Also, high taxation of alcohol and tobacco aiming to reduce consumption may be detrimental to the interests of specific segments of the population or geographical regions whose main source of income is production of such commodities.

The imposition of taxes should also take into account the overall tax policy design. For example, in the context of the energy crisis faced by the EU in 2022, an increase of excise rates for polluting energy products is questionable when coupled with multiple country-based exemptions, reductions and preferential regimes supporting the low prices and availability of the same products (e.g., through reduced VAT rates, refunds for final consumers etc.).

In view of the above considerations, a more nuanced and balanced approach may be achieved through the application of differentiated taxation policies which are based on the level of harm the respective taxable products pose thus distinguishing between products falling within a similar tax and product category.

II. Differentiated taxation

Although "differentiated taxation" is not *per se* a scholarly or public policy term it is recognized by economic and health economic researchers. By "differentiated taxation" we refer to a taxation that provides for a different tax burden and treatment of certain product or limited number of products deemed to entail different "levels" of a specific negative externality as a major

⁸ "A Behavioural Economics Perspective on Tobacco Taxation", p. 612.

⁹ "Implications of behavioural economics for tax policy", p. 26.

characteristic. The said externality may relate to risks for the human health for the consumer or those who surround him, detrimental environmental effect or both.

The most common goal of the differentiated taxation is, on the one hand, to impact the consumers' behavior by provision of stimuli toward either a complete discontinuation of the product's usage or, where possible, switch to a substitute (alternative) presumably posing less harm to health and/or the environment. As a second effect, such taxation influences the research and development activities of producers/traders so that they shift their investments, manufacturing and distribution towards products with lower risk levels. From behavioral point of view, changing consumers' habits would mean that the goal of a corrective tax is achieved. It may seem like a paradox, therefore, that even where fiscal revenues collected from a corrective tax are not significant, the results in terms of human health and/or environment may nevertheless be positive.

Differentiated taxation, therefore, may be regarded as aiming to influence human behavior in a specific manner by altering decision-making stimuli. The said stimuli may be negative such as taxation leading to increased price levels discouraging the manufacturing or usage of the specific product but also positive, by allowing the producers and consumers to easily switch to less hazardous alternatives by making substitutes more affordable and attractive or reduce harm/ replace most harmful contents with less harmful.

The said goals are usually targeted by means of a tax that is:

- (i) levied on consumption (most often final one)
- (ii) assessed as a one-off tax (rather being cumulative)
- (iii) applied to a limited number of products, which are explicitly differentiated, i.e., is not general tax
- (iv) aimed to make the production / consumption of the specific product less desirable from consumers' or producers' perspectives (or both)
- (v) targets the level harm/volume of harmful content/substance (e.g., ethanol content in alcohol), or on a product as a whole where its harmful content is regarded as being higher vis-à-vis such content in a substitute (e.g., conventional fossil fuels versus fossil fuels with decarbonization effect).

The type of tax that most closely meets the above indicative characteristics is excise duty or a tax with a similar profile and mechanism, even where not explicitly referred to as an excise tax. Having said this, we note that similar goals may be aimed through other indirect taxes such as VAT. The latter is used to achieve beneficial final effects usually through specific reductions or exemptions on less hazardous products. For example, reduced VAT rates may be applicable to certain category of products except for ones with "highest or most harmful" content (such as reduced VAT applied to beverages excluding alcoholic beverages, or healthy food products vs. unhealthy products).

Differentiated taxation is effective when producing behavioral response from producers and consumers such as reduced production / consumption or total cessation of detrimental products or a shift to less harmful alternatives, therefore, having overall positive impact on public health, environment, or both.



Executive Summary

Executive Summary

I. Analysis - purpose, scope, sources

The purpose of the current report is to present our findings in relation to "differentiated taxation" applied to several types of products. The analyzed products entail specific negative externality as follows:

Type of product	Negative external effect
Energy products	Environment and human health
Food and non-alcoholic beverages	Human health
Alcohol beverages	Human health
Tobacco and nicotine products	Human health

The analyzed products are not identical and have specific economic and social characteristics both in terms of their production and usage. The common denominator for all is that taxation is deemed a factor with a significant potential to influence the level of their distribution and final consumption. Also, the targeted usage of the products is usually coupled with initiation of specific public activities also requiring targeted financing and subsidies (e.g., informational campaigns, sport activities, prevention).

Our report does not aim to draw conclusions regarding the health or environmental implications related to any of the products reviewed. Such aspects are taken into account solely to the extent that these impact the design of taxation policies already chosen or currently proposed/discussed in relation to a specific product.

We are using qualitative analysis by collecting and analyzing non-numerical data from several types of sources. The sources used may be divided into the following broad categories:

- Official legislative acts or proposals for such acts
- Framework policy documents or analyses by official institutions or public bodies (e.g., the European Commission, the World Health Organization)
- Analyses by private institutions, research organizations, scholarly articles.

II. Structure of the report and main conclusions

Our report is structured into four sections based on the type of product subject to analysis.

Below we provide an overview of each section along with the main findings.

Section 1 – Energy products

Energy products are subject to harmonized EU rules in the area of excise duties. Our study focuses on the development of the European legislative framework up to the current proposal for revision of Directive 2003/96.

Historically the EU legislative framework for energy products has been based on "economic" criteria which, as a primary objective, aimed to ensure the proper functioning of the single EU

market. This goal was to be achieved mainly through the setting of minimum taxation levels below which EU states are not allowed to tax energy products, as well as specific taxation regimes, rules and rates for certain activities / sectors.

The existing taxation is volume-based one and in practice favors polluting fossil fuels while providing little incentives for innovation toward more sustainable products. The environmental and health aspects have long been of secondary importance without the implementation of significant practical policies by Member States.

The goals of the Green Deal and the “Fit for 55” legislative package coupled with the increased usage of sustainable fuels, however, has gradually shifted the EU energy taxation to environmental and sustainability goals. This trend is evidenced in the current proposal for new energy directive which shifts the focus to tax differentiation of energy products based on their harmful nature, externality (polluting effect), energy content and environmental performance.

Section 2 - Food and non-alcoholic beverages

The specific content subject to differentiated taxation involves three examples of substances with presumed harmful effect on human health, namely: (i) salt, (ii) sugar and (iii) saturated fats. All three substances are not subject to harmonized taxation on EU level. In this regard, we have based our analysis on examples both from states within the EU (such as Hungary, Denmark) but also countries from across the world that have implemented specific taxation practices (e.g., Mexico).

In the reviewed cases, corrective taxation is usually effected through a tax entailing the specifics of an excise duty such as being one-off (not cumulative), indirect and levied on the stage of consumption. The main goal of the tax is to discourage/decrease the consumers’ usage of products containing volume/level of the specific harmful substance that exceeds an acceptable threshold while influencing the producers to switch to production with altered (less harmful) content usually below such threshold. Policy affecting the respective thresholds enables the gradual attainment of the desired behavioral effects thus counterbalancing the possible undesired social and/or economic effects from the imposed tax.

Section 3 - Alcoholic beverages

Alcoholic beverages are subject to harmonized excise taxation within the EU. For this reason, our report focuses on the EU legislative framework in this area with a comparative example for a specific taxation proposal in the UK (still not implemented as of the date of the report¹⁰).

The differentiated taxation for alcohol is based on three main approaches: (i) *specific* – i.e., alcohol per volume content, (ii) *unitary* based on volume and (iii) *ad valorem* based on sales price. The most suitable approach depends on the aim of the tax.

The proponents of the human health consideration related to alcohol consumption (such as the World Health Organization) predominantly consider that the specific method is most favorable

¹⁰ The official UK government website indicates that the changes to the duty structure for alcohol duty may take effect from August 2023 with temporary easement for certain wine products until February 2025. See: <https://www.gov.uk/government/publications/reform-of-alcohol-duty-rates-and-reliefs/reform-of-alcohol-duty-and-reliefs> accessed on 28 September 2022.

one to support health policies and encourage the innovation of alcohol producers toward low-strength drinks. The differentiation based on alcohol content is also a foundation of the proposal for a new alcohol policy in the UK.

Within the EU, the major differentiation for tax purposes between alcoholic beverages continues to be rather based on the historical distinction between several main tax categories of products: beer, wine, other fermented beverages, intermediate products and ethyl alcohol. This differentiation takes into account the existence of separate economic sectors related to each tax category. The main EU approach tackling health issues is oriented towards the introduction of lower excise rates for low-strength beverages (e.g., low-strength beer).

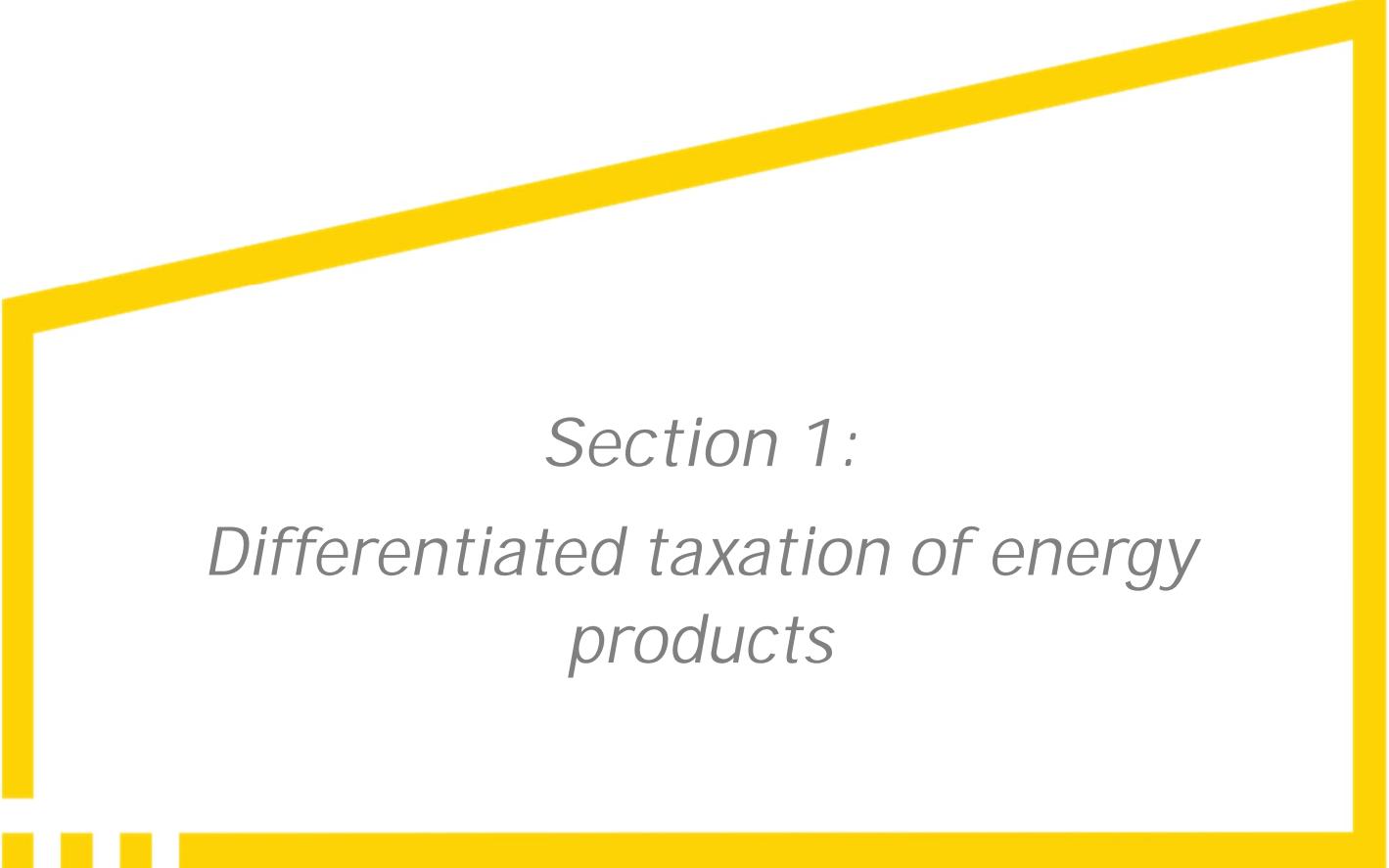
Section 4 - Tobacco and nicotine products

Currently, only combustible tobacco products (cigarettes, cigars, cigarillos and smoking tobacco) are within the scope of EU harmonized excise taxation. At this stage there is no harmonized common taxation for novel non-combustible alternatives such as heated tobacco products and nicotine delivery products covering, *inter alia*, e-cigarettes and nicotine pouches. In this regard our analysis takes into account both the EU-wide legislation regarding combustible tobacco products and specific approaches from EU countries currently applied to non-combustible alternatives (including Bulgaria).

Considering the serious health risks posed by tobacco consumption, the EU harmonized excise taxation covers combustible tobacco products for smoking and has as its primary goals both the protection of public health and ensuring the proper functioning of the single EU market. The general assumption is that health objectives may be achieved through higher taxation of tobacco products, i.e., by means of increasing the applicable EU rates (thus reducing the opportunities for "race to the bottom" taxation).

During the last decade the introduction of innovative non-combustible alternatives to smoking has led to the necessity for revision of Directive 2011/64/EU. Although Member States can apply their own fiscal policy, a revision of the Directive is preferable to ensure harmonization on Union level to smoothen the fragmented approaches applied by different Member States, while taking into account the practices already used effectively across the EU (some Member States, like Bulgaria, tax heated tobacco products and lately e-cigarettes but not nicotine pouches, while others tax all three categories).

Based on our research, we consider that future EU-wide taxation of tobacco and nicotine products should be based on differentiated principle considering their specifics with the main ones being the presence or absence of combustion process and the potential that non-combustible products provide for reduced health risks to smokers, who do not quit completely the use of tobacco or nicotine.



*Section 1:
Differentiated taxation of energy
products*

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Differentiated taxation of energy products

In the current section we analyze the development of the EU-wide legislative framework for energy products and, more specifically, the shift from economic-driven approach in the 1990s to a more “nuanced” current policy combining issues of economic growth, public health, environmental considerations, and incentives for innovation toward sustainable fuels. The analysis is structured chronologically based on three main stages, i.e., beginning with the initial excise legislation for mineral oils in the 1990s, continuing with the EU Energy Taxation Directive (“ETD”) and concluding with the current proposal for amendment of the ETD.

I. First stage – initial EU framework regarding mineral oils

1. Common energy legislation in the excise area

The initiative toward implementation of an EU-wide framework on harmonization of excise duties is based on the Treaty establishing the European Community and, later, on the Treaty on the Functioning of the European Union.¹¹ The first unsuccessful attempt for introduction of framework directive on excise duties dates back from the 1970s and provides for a harmonized system for excise duties covering “mineral oils.”

In the 1990s two specific pieces of legislation were aimed at mineral oils (energy products):

- Council Directive 92/81/EEC of 19 October 1992 on the harmonization of the structures of excise duties on mineral oils (“Structures Directive”); and
- Council Directive 92/82/EEC of 19 October 1992 on the approximation of the rates of excise duties on mineral oils (“Rates Directive”).

The Structures Directive includes definitions of the mineral oils by referring to their codes from the Combined Nomenclature (CN) itself based on the Harmonized System of the World Customs Organization. The CN classification has remained a crucial element in terms of the excise taxation for energy products, namely, only goods under specific CN codes are subject to excise duty and special monitoring. The Structures Directive stipulates that oils are subject to excise duty if intended for use, offered for sale or used as heating fuel or motor fuel.

In turn, the energy Rates Directive provided for the applicable tax rates to mineral oils. Any product not listed as “mineral oil” but used for heating or motor fuel purposes was taxed at the

¹¹ “Introduction to the European Excises (2008/118/EC)”, B. Terra, J. Kajus & H. Winkels, Global Topics IBFD.

rate for the equivalent mineral oil. The mineral oils were subject to taxation based on the volume criterion (e.g., per 1,000 liters, per 1,000 kg.).

In terms of exemptions and reduced rates, the legislation provided for specific activities and economic sectors subject to favorable treatment. These, *inter alia*, included mineral oils supplied for use as fuel for air navigation or navigation within Community waters including fishing.

The proper functioning of the single EU market was to be achieved by means of approximation of the excise duty rates on mineral oils as provided for in the Rates Directive. In this regard, the said directive did not provide for a final rate which must be reached by all Member States and only prescribed minimum rates applicable to certain types of mineral oils.

2. Tax differentiation principles in the initial legislation for mineral oils

The initial framework was based on several main principles. To begin with, the legislation regarding mineral oils aimed to address the following objectives:¹²

- Reduce the proliferation of different national rates undermining the single market and the liberalization of the energy markets of natural gas and electricity; and
- Overcome the lack of harmonized national rules and rates for same products.

The main goal, therefore, is the EU-wide approximation of the minimum excise rates to be achieved by means of differentiated minimum rates under which Member States are not allowed to tax mineral oils. This aim is an "economic" one with the focus being on the smooth functioning of the single European market.

Second, the main criterion for which mineral oils are taxed is their usage as either heating or motor fuels. The tax base is the volume of the products expressed in liters and kilograms.

Third, from the very introduction of the excise energy framework, the European air and maritime industries have enjoyed preferential treatment often leading to exemption of their fuels. These preferential tax regimes reflect another economic goal, namely, ensuring the competitiveness of specific EU economic sectors.

Finally, although the excise duties (along with reduced VAT rates) are recognized by the EU legislators as one of the instruments for tackling environmental problems, the initial EU legislative acts in the excise area do not have such environmental issues as their primary objective. Accordingly, these issues are not taken into account for tax differentiation purposes.

¹² Commission staff working document "*Evaluation of the Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity*", Brussels, 11.9.2019, SWD (2019) 329 final, p. 11-13.

II. Second stage - Energy Taxation Directive (ETD)

1. Overview of the ETD

Directive 2003/96/EC or the so called "Energy Taxation Directive" (ETD) repeals Directives 92/81/EEC and 92/82/EEC, thus becoming the main EU legislative act in the area of excise duties on energy products.

The ETD broadens the scope of energy products (no longer referred to as "mineral oils") by also including electricity, natural gas and coal. The ETD reiterates some of the taxation principles from the repealed acts. In this regard, it provides for minimum rates according to the different types of products based on CN codes and usages of energy product (as motor or heating fuel). The unitary (volume) principle is also preserved.

As from January 2004 to January 2010, the minimum levels of taxation applicable to motor fuels are determined in Annex 1.A of the ETD.

	1 January 2004	1 January 2010
Leaded petrol (in EUR per 1,000 l.)	421	421
Unleaded petrol (in EUR per 1,000 l.)	359	359
Gas Oil (in EUR per 1,000 l.)	302	330
Kerosene (in EUR per 1,000 l.)	302	330
LPG (in EUR per 1,000 kg.)	125	125
Natural gas (in EUR per gigajoule)	2.6	2.6

Irrespective of the above, the ETD provides for lower rates in relation to motor fuels used for specific industrial and commercial purposes such as agriculture, forestry, stationary motors, plant, and machinery used in construction, civil engineering and public works and other. The rates as per Annex 1.B of the ETD are:

Gas Oil (in EUR per 1,000 l.)	21
Kerosene (in EUR per 1,000 l.)	21
LPG (in EUR per 1,000 kg.)	41
Natural gas (in EUR per gigajoule)	0,3

On the other hand, the minimum levels of taxation applicable to heating fuels and electricity are based on the type of use, i.e., business vs. non-business use. The "business use" is defined as the use by a business entity, which independently carries out, in any place, the supply of goods and services, whatever the purpose or results of such economic activities. The economic activities comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions.

The excise rates on heating fuels and electricity provided for Annex 1.C of the ETD are:

	Business use	Non-business use
Gas Oil (in EUR per 1,000 l.)	21	21
Heavy Fuel Oil (in EUR per 1,000 kg.)	15	15
Kerosene (in EUR per 1,000 l.)	0	0
LPG (in EUR per 1,000 kg.)	0	0
Natural gas (in EUR per gigajoule)	0,15	0,3
Coal and coke (in EUR per gigajoule)	0,15	0,3
Electricity (in EUR per MWh)	0,5	1,0

Similarly to the repealed directives, products not explicitly specified but used as motor or heating fuel are to be taxed at the equivalent product rate.

2. Tax policies performed through the ETD

In the current section we outline several points regarding the tax differentiation principles in the ETD which, almost two decades later, predetermine the dominance of conventional fuels within the European energy mix.

- Objectives of the energy legislation

Based on the recitals to the ETD, the European Commission Staff Working Document "Evaluation of the Council Directive 2003/96/EC of 27 October 2003" summarizes the objectives of the ETD in the following way:¹³

Primary objective	Secondary objectives
Proper functioning of the internal market (Recitals 2, 3, 4, 8, 15, 19, 24 and 26)	<p>Support the Member States in achieving other EU policies such as:</p> <ul style="list-style-type: none"> - environmental protection and accomplishment of international commitments (recitals 6, 7, 11, 12, 25, 26, 28 and 29); - energy efficiency (recitals 29); - promoting the EU economy by maintaining / improving the competitiveness of EU companies in the international framework (recitals 8, 23 and 28); - transport policies (recitals 12, 19 and 23); - redirecting fiscal policy to combat unemployment and consideration for the social dimension (recitals 11 and 28).

¹³ Commission staff working document "Evaluation of the Council Directive 2003/96/EC", p. 7.

Considering the above, the harmonization of the energy taxation through the ETD is primarily meant to achieve "economic" aims by avoiding the undesired effects of energy tax competition between Member States. This harmonization should strengthen the internal market by tackling distortions of competition from relocation of energy consumers or businesses from Member States with less beneficial tax regimes to ones with more beneficial ones.

As secondary objectives, the ETD allows EU states to achieve other goals such as environmental protection and climate related commitments (the Kyoto Protocol), energy efficiency, promoting the international competitiveness of EU companies, transport policies. Aside from environmental protection, the remaining secondary goals also pursue beneficial economic effects.

Therefore, the ETD widens the scope of taxable products (by treating competing energy products in the same way) and establishes updated minimum rates (in order to avoid Member States competing on taxes) while providing certain flexibility for pursuing other policy goals through taxation.¹⁴

The ETD retains a structure based on minimum levels for the following groups: energy products used as motor fuels, products used as motor fuels for specific industrial and commercial purposes (with reduced minimum taxation levels), heating fuels and electricity.

- Timeframe and tax rates

The required minimum rates are set up to the calendar 2010 without further indexation. This approach leaves a "gap" by not accounting for changes in prices and inflation after reaching the 2010 threshold.

In terms of motor fuel rates, within the set period the ETD provides only for a minimal increase in the motor fuel rates and solely in relation to two products (gas oil and kerosene with increase of approx. 9.3%). On the other hand, leaded petrol, petrol, LPG and natural gas remain without any increase. The said two products (gas oil and kerosene), however, along with LPG and natural gas may be subject to much lower rates in cases when used for specific industrial and commercial purposes thus opening the door for further decrease in their rates.

Regarding heating rates, kerosene and LPG again are treated favorably by being practically exempt while significant pollutants such as coal and coke are granted the lowest rates.

The maritime and aviation sectors are supported with practical exemptions. The potential usage of innovations such as advanced and environmentally friendly products, although provided for in the ETD as optional exemption, is left to the discretion of Member States in practice making it less likely to be implemented.

The overall note to be made, therefore, is that while the ETD considers the environmental aspect in the form of optional exemptions, the rates are structured in a way supporting the economic and competitiveness criteria. This results in excessive favoring of "polluting" products or specific industries not having incentives for introduction of more advanced fuels.

¹⁴ Ibid., p. 11-13.

- Taxation levels within the EU

The Impact Assessment accompanying the 2011 proposal for amendment of the ETD, indicates that, among the questionable effects on EU-wide level, is the creation of two "clusters" of states applying different tax burden.¹⁵

- "Low-taxing Member States" taxing at rates close to the minimum levels and introducing taxation mainly due to the common minimum rates; except for Slovenia, most of the new Member States fall in this group.
- "High-taxing Member States" with tax levels above the minima with the Nordic countries among the highest taxing Member States (especially for heating fuels); for these states the existence of *de minimis* criterion is important to reduce competitive disadvantages for their industries.

The abovementioned issue regarding differentiation of excise taxes in the ETD is evident when assessing energy product rates in the Bulgarian excise legislation as of the date of the current analysis. Considering that Bulgaria is an EU member from 2007, the taxation rules in the ETD are implemented on local level through the Bulgarian Excise Duties and Tax Warehouses Act (EDTWA). In this regard, about 15 years after the accession, the Bulgarian excise rates for most energy products still remain close to the 2010 minimums set by the ETD (i.e., to the lower end). This also concerns the most polluting motor fuels as well as the coke and coal thus practically reducing the incentives for innovation toward advanced fuels.

III. Third stage – proposal for amendment of the ETD from 2021

In 2021, the European Commission presented a proposal for amendment of the Energy Taxation Directive.

In order to analyze the rationale behind the new proposal, it is first necessary to consider the areas and shortcomings within the current ETD that are addressed with the new project. This also concerns recent scholarly developments regarding the role of energy taxation as a tool for ensuring sustainable economic growth, fair social policy and clean environment.

1. Shortcomings of the ETD and new developments in energy taxation

The current section is primarily based on the conclusions from the European Commission Staff Working Document "Evaluation of the Council Directive 2003/96/EC of 27 October 2003."¹⁶ Without aiming to be exclusive, we have summarized some of the main problems regarding the ETD within the context of the applicable taxation policies as identified by the Commission.

- Outdated rates and flexibility in application

The absence of an increase in the minimum rates at EU level since 2010 has eroded the tax-induced price signal supposed to encourage investment in energy-efficient technologies. Due to the lack of provisions, the favorable tax treatment of low carbon fuels is not supported and

¹⁵ Commission staff working document "Evaluation of the Council Directive 2003/96/EC", p. 14.

¹⁶ Ibid., at p. 16 - 38.

renewable energy can be taxed at a higher rate than a competing fossil fuel (as long as the minimum rates are respected).

As a result, some Member States have increased their national level of taxation while others have not, leading to distortion of competition within the EU market.

On the other hand, the ETD allows for flexibility of taxation based on factors such as sulphur and energy content, CO2 emissions or biofuel share (component) of the product, as well as differentiation based on specific usages (e.g., local public transport, waste collection, disabled people, ambulances etc.) creating a patchwork of differing national rates for the same products.

- Unitary taxation based on volume criterion

The taxation of fuels solely according to their volume and without considering their energy content discriminates against renewable fuels in favor of conventional fuels (especially gas oil), thus contradicting the promotion of renewable energy sources. Therefore, the ETD does not ensure the equal treatment of energy products based on their negative externalities (e.g., air pollutants).¹⁷

- Disparities between nominal and effective excise rates

The ETD has not prevented the occurrence of significant differences in the "effective" rates, i.e., the actual tax burden in comparison with the one provided for by the "nominal" rates of taxation. This disparity is a cumulative result of national tax rates applied jointly with the use of sectoral and other tax exemptions, altering the rates applied to certain usages as well as amending the tax base, the beneficiaries, or the criteria for tax reliefs.

- Sector-specific exemptions and reductions

The presence of sector-specific energy tax exemptions or reductions, notably in the aviation and maritime sector as well as agricultural/fisheries and for energy-intensive industries, has weakened the incentives for investing in more energy-efficient production processes in these sectors. Furthermore, the preferential treatment of certain industries distorts competition between industrial sectors and promotes inefficient and polluting modes of transport.

Also, the broad definitions for exemptions and reductions, opens the door to highly diverging EU practices and discretionary national implementation. This, in turn, increases the lack of harmonization necessary for the functioning of the EU internal market.

The use of optional exemptions and reductions further increases the complexity of the implementation of the ETD. In some Member States, exemptions and reductions granted to large industrial users result in an effective rate 90% lower than the nominal rate. In other Member States, the impact of reductions for the same type of consumer may be limited to below 5%.¹⁸ Finally, the lack of differentiation between the different fuels used by different sectors covered

¹⁷ Ibid, p. 9.

¹⁸ Commission staff working document "*Evaluation of the Council Directive 2003/96/EC*", p. 28.

by the mandatory exemptions does not facilitate the reduction of the price differences between fossil and sustainable fuels.¹⁹

- Insufficient stimuli for innovative products

The current ETD regime does not ensure the preferential treatment of newer energy products and applications. By default, the ETD applies standard tax treatment to electricity and biofuels without differentiating between renewable (lower energy) products and fossil-fuel ones or between their environmental performance.

This leads to favourable treatment of fossil fuels compared to their low-carbon alternatives (an issue especially pronounced within the transport sector). Alternative transport fuels (e.g., hydrogen, synthetic fuels, bio-methane, renewable fuels of non-biological origin) are not even addressed with specific legal provisions leaving their taxation rates to be based on the "equivalency" principle (thus equating them with fossil fuels).

In the absence of differentiation for biofuels, Member States apply their own classifications. These are often diverging or cannot be applied to the characteristics of biofuels produced in other Member States leading to insecure business environment for biofuel producers operating across borders.

One of the areas where the existing rules are outdated is electricity taxation.²⁰

The present ETD taxes electricity delivered for consumption irrespective of its source and its use without differentiating between low carbon and carbon-intensive electricity generation. The electricity is increasingly used as a propellant for electric vehicles. However, the ETD does not contain a specific minimum level of taxation for electricity used as propellant. At present, it only provides minimum levels of taxation for business and non-business use (lower than those for motor fuels). Furthermore, the electricity used as propellant in passenger cars is not covered by the optional or mandatory tax reductions and exemptions.

Similarly, the ETD lacks rules for preferential tax treatment of shore-side electricity which allows ships to turn off their fossil fuels engines and plug into an electrical grid thus generating environmental benefits (reduction of local air and noise pollution). As of 2019, only four Member States have applied for a derogation to be authorized to apply a reduced tax rate to electricity directly supplied to vessels berthed in ports.

- Taxation policies and economic growth

The role of the tax policy in fostering growth has been subject to 2008 research by the Organization for Economic Cooperation and Development (OECD) entitled "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries." The study ranks taxes with respect to their relationship to economic growth. One common policy recommendation for EU Member States is to shift taxes away from labor to other tax bases (e.g., environmental taxes) less detrimental to growth.²¹ Environmental taxes are deemed as contributing to economic growth by providing cost-effective way to reduce pollution emissions

¹⁹ Commission staff working document "*Impact assessment report*", p. 28.

²⁰ Commission staff working document "*Evaluation of the Council Directive 2003/96/EC*", p. 35-37.

²¹ *Ibid*, p. 49.

and correct other negative externalities. Therefore, an increase in the level of environmental taxation could lead a positive impact on economic growth and employment.

In the paper entitled "The Environment and Directed Technical Change", a research team from the Department of Economics at the Massachusetts Institute of Technology illustrates that energy taxation can play an important role in changing human behavior and incentivizing "cleaner" technologies without, in the long term, running contrary to the goal of economic growth. Such effect is necessarily reached both by means of taxation (negative incentive) and stimuli encouraging the innovative technologies (positive incentive). The main argument presented by the authors is that:

*"In the empirically plausible case where the two sectors (clean and dirty inputs) are highly substitutable, immediate and decisive intervention is indeed necessary..... However, optimal environmental regulation, or even simple suboptimal policies just using carbon taxes or profit taxes/research subsidies, would be sufficient to redirect technical change and avoid an environmental disaster. Moreover, these policies need to be in place for only a temporary period, because once clean technologies are sufficiently advanced, research would be directed towards these technologies without further government intervention. Consequently, environmental goals can be achieved without permanent intervention and without sacrificing (much or any) long-run growth."*²²

2. Overview of the 2021 proposal

The new proposal is part of the European Green Deal (EGD) and the "Fit for 55" legislative package which focus on environmental and climate issues. Based on the EGD strategy and a comprehensive impact assessment, the EU Commission proposes a plan to increase the EU's binding target for 2030 to, at least, 55% net emission reduction.

In the EGD, the EU Commission commits to review the ETD focusing on environmental issues and ensuring that energy taxation is aligned with climate objectives. Taxation plays a direct role in supporting the green transition by sending the right price signals and providing the incentives for sustainable consumption and production.

In this regard, in its 2019 Communication the EU Commission has stressed that a future energy taxation framework should entail the following goals:

- Support the clean energy transition;
- Contribute to sustainable and fair growth;
- Reflect social equity considerations.²³

²² "The Environment and Directed Technical Change" by Daron Acemoglu, Philippe Aghion, Leonardo Bursztyn, and David Hemous, accessed at: economics.mit.edu/files/8076 on 15 September 2022.

²³ Commission staff working document "Evaluation of the Council Directive 2003/96/EC", p. 18.

The new proposal places the above criteria on equal footing with the "economic" ones aimed at proper functioning of the internal EU market and maintaining competitiveness of the EU businesses.²⁴

As noted by the EU Commission, the revised directive should focus on environmental and climate issues in order to support the transformation of the EU's economy to a sustainable future. This means that taxation should be aligned with climate and environmental objectives.

Further to this, taxation can enhance other key EU policies and help achieve these objectives by creating proper incentives to change behavior as well as facilitate the right environment for innovation. The inclusion of enhanced taxation elements in the EGD supporting other policy instruments acknowledges the importance of the "polluter pays" principle and the role of behavioral taxation by providing the incentives to steer behavior of producers and consumers.²⁵

Consequently, according to the report, while ETD historically has been an instrument for collection of tax revenue, currently the environmental objective of taxation has gained relevance and especially the necessity to decrease incentives for usage of fossil fuels. The taxation of heating and motor fuels should reflect their impact on environment and human health which also involves removing the existing disadvantages for clean technologies.²⁶

3. Tax differentiation as per the 2021 proposal

Below we have summarized some of the important points in the new ETD proposal. The summary is based on the European Commission's Proposal for a Council Directive restructuring the Union framework for the taxation of energy products and electricity.²⁷

- Taxation based on energy content and environmental performance

Among the major novelties is that the minimum rates will be based on energy content (in gigajoules) of each product and its environmental performance, rather than on volume. This logic should allow for diversified objectives such as energy efficiency, reduction of greenhouse gas emissions and revenue generation.

Taxation based on energy content is considered a better reference to compare different energy products and electricity and to eliminate the disadvantageous tax treatment of less energy-intensive products (biofuels). The concept of "environmental performance" and the corresponding ranking of applicable rates acknowledges the specific characteristics of different products.

Energy taxation will be based on the net calorific value of the energy products and electricity as set out in Annex IV to Directive 2012/27/EU. In the case of products derived from biomass, the reference values will be those set out in Annex III to Directive (EU) 2018/2001.

²⁴ Proposal for a Council Directive restructuring the Union framework for the taxation of energy products and electricity (recast), Brussels, 14.7.2021, COM (2021) 563 final, 2021/0213 (CNS).

²⁵ Commission staff working document "*Impact assessment report*", p. 6.

²⁶ Ibid.

²⁷ Proposal for a Council Directive restructuring the Union framework for the taxation of energy products and electricity (recast).

The minimum levels of taxation are set out according to the environmental performance (e.g., sustainable biofuels would be taxed with lower rates) and are expressed in EUR/GJ. In 2023, the base value for one unit of energy content is set at 0.15 EUR/GJ, which corresponds to 0.5 EUR/MWh, the lowest minimum rate in the ETD for electricity as well as to the current minimum taxation of business use for some heating fuels (natural gas, coal and coke).

Taking this value, the minimum rates would range from 0.15 EUR/ GJ to 10.75 EUR/GJ without considering the inflation. The level of taxation of petrol (10,75 EUR/GJ) and of electricity (0,15 EUR/GJ) are thus the two reference values setting the range for all the other minimum rates. This differentiation of rates provides signals to consumers for better performing energy products and technologies.

The proposal sets differing rates for motor fuels for transport (e.g., used as propellants), motor fuels used for specific purposes (e.g., in the primary sector), for heating fuels, electricity and innovative products.

The second basic differentiation is between the rates for motor fuels and those for heating fuels whereby the latter are significantly lower than the former and are set closer to the rates for motor fuels used for specific purposes. As main drivers toward the EU's clean energy transition, the electricity along with advanced biofuels, bioliquids, biogases and renewable hydrogen are granted the lowest tax rates.

Better harmonization of the minimum levels of taxation for motor fuels, heating fuels and electricity is also to be achieved by removing the distinction between commercial and non-commercial use of gas oil as motor fuel as well as business and non-business use for heating fuels and electricity.

The rates may be summarized as follows:²⁸

Proposed minimum tax rates		
Fuel types	Example fuels	Minimum tax rate
Conventional fossil fuels and non-sustainable biofuels	Gas oil, petroleum	10.75 EUR /GGJ for motor fuel and 0.9 EUR / GGJ for heating fuel
Fossil-based fuels supportive of decarbonization in the short term	Natural gas, Liquefied petroleum gas (LPG)	For the first 10 years: 7.17 EUR/GGJ for motor fuel and 0.6 EUR/GGJ for heating
Sustainable but not advanced biofuels	Food crop derived biofuels Wood mass derived biofuels	5.38 euros/GGJ for motor fuel and 0.45 euros/GGJ for heating
Advanced sustainable biofuels, electricity, biogas and renewable non-biological fuels	Renewable hydrogen, Electricity	0.15 euros/GGJ

²⁸ "Energy Taxation Directive", KPMG International accessed at:

<https://home.kpmg/xx/en/home/insights/2021/08/energy-taxation-directive.html> on 16 September 2022.

The position paper of the European Automobile Manufacturer's Association (ACEA) on the ETD proposal illustrates the current tax rates per Member State regarding three of the most widely used energy products (petrol, diesel and natural gas). The applicable rates for Bulgaria imply that future increase would possibly be required in terms of the rates for all three products.²⁹

	Petrol		Diesel		Natural gas	
	€/litre	€/GJ	€/litre	€/GJ	€/kg	€/GJ
Austria	0.482	14.2	0.397	10.5	0.076	1.66
Belgium	0.6	17.6	0.6	15.9	0	0
Bulgaria	0.363	10.7	0.33	8.7	0.20	0.43
Croatia	0.51	15.0	0.405	10.7		
Cyprus	0.429	12.6	0.4	10.6		
Czech Republic	0.477	14.0	0.37	9.8	0.118	2.6
Denmark	0.638	18.7	0.435	11.5	0.13	2.86
Estonia	0.563	16.5	0.372	9.9	0.049	1.07
Finland	0.724	21.3	0.513	13.6	0.261	5.74
France	0.672	19.7	0.609	16.1	0.073	1.61
Germany	0.655	19.2	0.47	12.4	0.176	3.86
Greece	0.7	20.6	0.41	10.9	0	0
Hungary	0.345	10.1	0.317	8.4	0.123	2.70
Ireland	0.619	18.2	0.515	13.6	0.118	2.60
Italy	0.728	21.4	0.617	16.3	0.004	0.09
Latvia	0.509	15.0	0.414	11.0	0.122	2.68
Lithuania	0.466	13.7	0.372	9.9	0.298	6.56
Luxembourg	0.516	15.2	0.404	10.7	0	0
Malta	0.549	16.1	0.413	10.9		
Netherlands	0.813	23.9	0.522	13.8	0.216	4.75
Poland	0.374	11.0	0.33	8.7	0.113	0
Portugal	0.668	19.6	0.513	13.6	0.126	2.48
Romania	0.375	11.0	0.368	9.1	0.118	2.78
Slovakia	0.514	15.1	0.368	9.7	0.170	2.60
Slovenia	0.445	13.1	0.464	12.3	0.052	3.74
Spain	0.504	14.8	0.379	10.0	0.270	1.15
Sweden	0.643	18.9	0.452	12.0		5.92
Current EU minimum rate	0.359		0.33			
Proposed EU min rate 2023		10.75		10.75		7.17

- Categorization of energy products

In relation to the applicable rates, the energy products will be grouped based on their environmental performance into several categories for motor and heating fuels. The same minimum rate would apply to each energy product within a category according to their use. The categories, ranging from highest to lowest excise rates are distinguished as follows:

- Conventional and most harmful fossil fuels - petrol, gasoil, kerosene and non-sustainable biofuels
- Fossil-based fuels with certain decarbonization effect - LPG, natural gas, non-sustainable biogas and non-renewable fuels of non-biological origin
- Sustainable but not advanced biofuels – food and feed crop biofuels and biogas
- Sustainable advanced biofuels and biogas
- Low-carbon fuels, renewable fuels of non-biological origin, advanced sustainable biofuels and biogas, electricity, hydrogen of renewable origin.³⁰

The highest minimum rates apply to traditional fossil fuels due to their poorer environmental performance compared to other energy products. The minimum rates will decrease (except for

²⁹ "Position Paper – Energy Taxation Directive", ACEA, European Automobile Manufacturers' Association accessed at: <https://www.acea.auto/publication/position-paper-energy-taxation-directive/> on 16 September 2022.

³⁰ Proposal for a Council Directive restructuring the Union framework for the taxation of energy products and electricity, Explanatory memorandum, p. 4.

kerosene for aviation) for each subsequent category with the lowest minimum rate applied to category (v). It is envisaged that, following 10-year period, the increase of the rates will practically merge categories (ii) and (iii) into category (i).

The electricity is always among the least taxed energy sources in view of encouraging its use (such as in the transport sector).

- Transitional period and gradual adjustment of rates

In order to avoid a shock effect, the proposal provides for a transitional period of 10 years in which minimum excise rates will increase gradually. The most sustainable energy products will be exempt from taxation over this 10-year period.

For the purposes of achieving the transition, each respective energy product use (as motor fuel or as heating fuel) is subject to two minimum excise duty rates, i.e., one rate for the beginning and one for the end of the transitional period. In this relation, the increase in the minimum levels of taxation is fixed at one tenth per year until the end of the transitional period.

- Annual indexation of rates with inflation

To reflect the "real" value of the minimum levels of taxation, the rates are to be adjusted yearly. The alignment is made based on the EU-wide harmonized index of consumer prices excluding energy and unprocessed food.

- Scope and new products

The revised ETD includes in its scope only products used as motor or heating fuel and electricity. In cases where a product consists of a mixture of one or more products, the taxation of each component should be determined accordingly, based on the applicable rates and independently from the CN code under which the product falls as a whole. Among the important novelties is the inclusion of new "energy products" within the scope of the ETD. Examples include hydrogen, ethyl alcohol and other sprits denatured and used as heating or motor fuel, fuel wood, peat, wood charcoal, pellets, ammonia, esters and organic composite solvents/thinners.

- Exemptions and reductions

The exemptions or reductions are allowed if they can be justified from an efficiency and environmental protection perspective. Examples for which exemptions are applicable involve electricity from renewable sources and electricity produced from combined heat and power generation (provided that the combined generators are environmentally friendly according to the EU definition) as well as renewable fuels of non-biological origin, advanced sustainable biofuels, bioliquids, biogas and advanced sustainable products falling within CN codes 4401 and 4402.

- Energy products used in aviation and maritime industries

The fuel used in the aviation and maritime sectors has traditionally had a privileged tax regime leading to full exemption. These policies will be amended as per the proposal. To align with the objectives of the EGD, non-sustainable fuels supplied for aviation and maritime navigation generally will be subject to taxation. In this regard, the kerosene in the aviation and the heavy

oils in the maritime industry will no longer be fully exempt for intra-EU voyages (e.g., intra-EU passenger flights, intra-EU ferry and fishing) and the applicable rates will gradually increase.

As for the mandatory exemptions in the aviation sector, the proposal provides for such in terms of fuel used for cargo-only flights as well as sustainable alternative fuels and electricity. Regarding the maritime industry, the revised ETD includes minimum “zero” rate for ten years on sustainable alternative fuels (including sustainable biofuels and biogas, low-carbon fuels, advanced sustainable biofuels and biogas, and renewable fuels of non-biological origin) and electricity.

In conclusion, we stress the necessity for aligned overarching European policies regarding energy products. The expected introduction of new EU excise system should comply with taxation criteria applied by different Member States and the current economic developments on EU level. This concerns not only excise duties but also other taxes (e.g., VAT) and measures such as compensations or reductions for final consumers.

The energy crisis experienced by Member States in 2022 has led to patchwork approaches which are inconsistent with the overall long-term EU goals toward sustainable fuels. For example, in 2022 (more than two decades after the adoption of the ETD) Bulgaria has introduced a “zero” excise rate for electricity from renewable sources. This measure is part of the economic package for tackling high energy prices and also includes excise exemptions for LPG and natural gas (until July 2025). Furthermore, the VAT legislation has introduced a reduced 9% VAT rate for natural gas (until July 2023). The said measures are adopted with the aim of addressing recent energy market developments and to mitigate the negative impact of high energy prices and inflation on businesses and households. Similar policies are introduced in other Member States. The said approaches, in turn, should be aligned with the policies of the revised ETD as, otherwise, the different sets of Union and national legislation may turn out to pursue non-aligned or even contradictory goals.

IV. Tax differentiation of vehicles and electricity as motor fuel

Along with the announcement of the “Fit for 55” package aiming to reach the target for 55% reduction of carbon emissions by 2030 and climate neutrality by 2050, the EU has presented its long-term strategy for reducing usage of polluting fossil fuels in transport. Coupled with increasing use of electricity as a propellant for innovative motor vehicles (“electric vehicles” or “EVs”) the said targets will be of high significance both for climate and tax policies within the EU.

- Road vehicles and tax differentiation

While taxation of vehicles has for decades been part of domestic tax policies within the EU countries, Member States have historically utilized differing approaches.

A 2012 paper published by a research team from Universitat Politècnica de Catalunya, Barcelona concludes that *“existing taxation in EU vehicles is very complex because the systems implemented in the EU member states can be both complex in themselves and quite different from country to country...not always the taxes levied are calculated efficiently for the most*

*polluting vehicles or for those that could affect the environment or health.*³¹ The same report differentiates between three general types of taxes: (i) purchase tax (such as registration tax); (ii) property tax (e.g. annual, road, circulation tax) and (iii) taxes on vehicle use (taxes on fuels, VAT).³²

In recent years, the focus has increasingly shifted toward tax differentiation based on pollution and carbon content. In this regard, in a 2022 study the European Automobile Manufacturers' Association indicates that 21 out of the 27 EU states apply CO2-based taxation to passenger cars with tax measures generally ranging from taxes on acquisition, ownership (including Bulgaria) and company vehicles.³³

According to a paper on EU taxation policies aimed to lower transport emissions by the independent non-profit International Council on Clean Transportation (ICCT), a key tax differentiation policy is increasing the tax burden for vehicles with high emissions while providing tax benefits for those with low emissions. Thus, if designed properly, taxes can facilitate efforts to reduce CO2 emissions and (along with emission limits that require manufacturers to develop, offer and sell low-emission vehicles) may provide consumers with incentives for buying low-emission vehicles thus creating market effect.³⁴ The paper distinguishes between taxes applied upon acquisition (purchase), ownership, consumption of fuel, usage of road infrastructure, private use of company cars as well as subsidies for low-emission vehicles.³⁵ The ICCT makes the following recommendations for tax differentiation related to policies toward lowering carbon emissions:³⁶

- (i) Tax advantages for low-emission vehicles at the point of purchase – ICCT argues that advantages at the point of purchase have a stronger influence on consumer choice (than annual tax payments) and play an important role in influencing consumer behavior (such as tax breaks upon registration and payment of higher taxes for polluting cars in the Netherlands or VAT exemption for low CO2 emission vehicles in Norway)
- (ii) Tax benefits for low-emission vehicles during their use - lower taxes and total costs for consuming electricity compared with higher taxes / prices for gasoline and diesel fuel can serve as an incentive for consumers to opt for cars propelled with electricity (e.g., increased taxes on gasoline and diesel in France)
- (iii) Accounting for emissions as part of the tax system - company cars play an important role in Europe and make up the highest proportion of new car registrations (e.g., zero-emission company car benefit and lower percentages applied when calculating benefit in-kind in the Netherlands)

³¹ Siamak Zahedi, Cremades, Lázaro "Vehicle Taxes in EU countries. How fair is their calculation?" accessed at: <https://upcommons.upc.edu/bitstream/handle/2117/18150/vehicles.pdf> on 15 May 2023.

³² Ibid.

³³ "CO2-based motor vehicle taxes in the EU, by country" from 1 July 2022, accessed at: <https://upcommons.upc.edu/bitstream/handle/2117/18150/vehicles.pdf> on 15 May 2023.

³⁴ Sandra Wappelhorst, Peter Mock, Zifei Yang, "Using vehicle taxation policy to lower transport emissions: an overview of passenger cars in Europe," Executive Summary, accessed at:

https://theicct.org/sites/default/files/publications/EU_vehicle_taxation_Report_20181214_0.pdf on 15 May 2023.

³⁵ Ibid, p. 3 – 7.

³⁶ Ibid, Executive Summary.

- (iv) Regularly balancing and re-adjusting the tax system to be self-sustaining – ICCT points out that policies facilitating purchase/maintenance of battery-powered electric vehicles and plug-in hybrids comparable to gasoline and diesel cars are usually more effective than one-off payments/subsidies for purchase of low-emission vehicles.

In Bulgaria taxation of road vehicles registered for operation on the Bulgarian road network (as well as ships and aircraft) is provided for in the Local Taxes and Fees Act. Bulgaria generally applies taxation based on ownership (taxable persons being natural or legal persons owning vehicles) with main criteria being type of vehicle, engine power and year of manufacture. In this relation, the tax imposed on internal combustion engine vehicles (ICEVs) considers, *inter alia*, applicable eco-friendly categories with higher tax imposed on vehicles with adverse environmental impact.

Broadly speaking Bulgarian taxation policies take into account the harmful impact of ICEVs with the country following the EU trends for higher taxation of vehicles having negative influence on the environment while simultaneously exempting from transport vehicle tax novel means of transport such as electricity cars, mopeds and motorcycles.

Having noted the above positive trend, the status of existing vehicle fleet in Bulgaria (i.e., predominantly old and polluting vehicles) is also indicative of the fact that when ownership tax is applied in isolation and is not being a considerable factor (including in monetary terms) impacting the vehicles' prices and maintenance, it is unlikely to contribute toward a major market shift in consumers' behaviors. Consequently, while higher tax on polluting ICEVs may seem a sound approach facilitating shift toward novel eco-friendly vehicles, this shift is practically impeded by low purchasing power of consumers coupled, among others, with very low taxes (e.g., excise duty) on polluting fuels thus providing limited stimuli for buying eco-friendly vehicles.

- Tax differentiation regarding e-vehicles

Differentiation measures within EU facilitating the transition to zero-emission of EVs may be broadly sub-divided into two major categories based on the impact of the stimuli on producers and consumers.

On the one side are “negative” policies (including tax measures) aiming to discourage further production and usage of ICEVs powered by polluting fossil fuels. These include increased taxes on most polluting fossil fuels (as discussed in the previous section) as well as new standards for setting CO₂ emission performance standards coupled with envisaged ban on ICEVs from 2035.

The other side of the spectrum involves “positive” measures facilitating production and consumption of innovative and environmentally friendly propellants (most notably electricity but also renewable hydrogen) as well as policies enabling electric mobility such as implementation of recharging points (infrastructure) for alternative fuels, stimuli for investments in electrification (for the car manufacturing sector) and for increased purchases and usage of EVs by companies and private consumers. Transition to “electrification on the road” is also facilitated by rapid developments within the high-tech sector including in terms of battery production.

As a general conclusion of the above observations, it could be said that long-term climate goals set within the EU are essential for the ultimate success of fiscal policies aimed at introduction of innovative taxation initiatives. Development of taxation framework based on differentiation principles will impact state budgets and choices made manufacturers and final consumers.

Below we comment on several major EU policies and incentives facilitating electrification within the transport sector.

- New CO2 emission performance standards

In July 2021, as part of its "Fit for 55" package, the EU Commission presented a legislative proposal for a revision of the CO2 emission performance standards for new passenger cars and light commercial vehicles. One year later, in October 2022, the European Parliament and Council reached provisional agreement ensuring that all new passenger cars and light commercial vehicles (vans) registered in Europe will be zero-emission by 2035.

Specific EU legislative measures include draft proposal for a Regulation amending Regulation (EU) 2019/631 as regards strengthening the CO2 emission performance standards for new passenger cars and light commercial vehicles.

As an intermediary step towards zero emissions, the new CO2 standard require average emissions by 2030 to come down to 55% for new cars and 50% for new vans. The policies include introduction of new methodology for assessment and data reporting of full life-cycle CO2 emissions of cars and vans sold on the EU market (to be presented by the Commission by 2025).³⁷

Specific steps include:³⁸

- (i) Funding which enables transition in the automotive sector - existing EU funding is to be channeled to zero-emission vehicles and related technologies with focus on small and medium-sized enterprises along the automotive supply chain as well as vulnerable regions and communities within the Union
- (ii) Providing exemptions and derogations until the end of 2035 for small manufacturers (with production levels of up to 10,000 new cars or 22,000 new vans per calendar year)
- (iii) Revising incentive mechanisms for zero and low-emission vehicles - current zero and low-emission vehicles incentive mechanism, which rewards manufacturers selling such vehicles (with emissions from zero to 50g CO2/km such as electric vehicles and well-performing hybrids) with lower CO2 emission reduction targets, will be adapted to meet expected sales trends; from 2025 to 2029, the benchmark is set at 25% for sales of new cars and 17% for new vans while as of 2030 the incentive will be removed.

The agreement was formally adopted by the EU Parliament and Commission in March 2023.

³⁷ "Deal confirms zero-emissions target for new cars and vans in 2035" accessed at:

<https://www.europarl.europa.eu/news/en/press-room/20221024IPR45734/deal-confirms-zero-emissions-target-for-new-cars-and-vans-in-2035> on 1 May 2023.

³⁸ Ibid.

It is worth noting that Germany has ensured specific exemption for cars running on e-fuels after 2035 (not initially envisaged in the proposal). E-fuels (kerosene, methane, methanol) are made by synthesizing captured CO₂ emissions using renewable or CO₂-free technologies and supposedly “balancing out” CO₂ released when the fuel is subsequently combusted in the engine. Although e-fuels are still not widely used, it remains to be seen whether the granted exemption would merely increase the lifeline of traditional ICEVs after 2035 or such fuels would open a novel innovation “lane” for car manufacturers. The Commission is further expected to propose how sales of e-fuel-only cars will continue working after 2035 (likely these vehicles will use technology preventing them from starting when filled with petrol or diesel).³⁹

- Charging infrastructure for e-vehicles

Development of easily accessible infrastructure for EVs is a critical aspect for promoting electric vehicles in Europe. This includes construction of easily accessible stations ensuring that electric vehicle owners have access to convenient charging options. Stations can be located both in public places (such as parking lots, shopping centers, markets, gas/fuel stations) as well in private locations (homes and business premises).

In addition to increasing the number of charging stations, it will be important to manage the network of stations and ensure that they are available and function properly. This includes monitoring usage and maintenance needs in specific areas/regions, as well as coordinating with infrastructure providers to ensure that drivers are able to locate charging stations across different regions and countries. For this purpose, EU states are required to set deployment targets for publicly accessible EV chargers for the decade to 2030, with an indicative ratio of 1 charger per 10 electric cars. The EU Green Deal provides a target of 1 million publicly accessible e-chargers to be installed by 2025.⁴⁰

The main EU legislative act aimed at reducing the carbon footprint from the transport sector by facilitating infrastructure for EVs is a proposed regulation on deployment of alternative fuels infrastructure with three main objectives:⁴¹

- (i) Ensuring existence of sufficient infrastructure network for recharging or refueling road vehicles or ships with alternative fuels
- (ii) Providing alternative solutions so that vessels at berth and stationary aircraft do not need to keep their engines running
- (iii) Achieving interoperability throughout the EU and making sure that the relevant infrastructure is easy to use.

³⁹ “EU countries approve 2035 phaseout of CO₂-emitting cars” by Kate Abnett accessed at:

<https://www.reuters.com/business/autos-transportation/eu-countries-poised-approve-2035-phaseout-co2-emitting-cars-2023-03-28/> on 1 May 2023.

⁴⁰ “Policies to promote electric vehicle deployment – Global EV Outlook 2021 Analysis” by International Energy Agency (IEA) accessed at: <https://www.iea.org/reports/global-ev-outlook-2021/policies-to-promote-electric-vehicle-deployment> on 15 May 2023.

⁴¹ “Infographic - Fit for 55: towards more sustainable transport” accessed at:
<https://www.consilium.europa.eu/en/infographics/fit-for-55-afir-alternative-fuels-infrastructure-regulation/> on 1 May 2023.

In terms of road transport, the project provides for installing recharging stations at least every 60 km on main roads (for passenger cars and trucks below 3.5 tons by the end of 2025 while for trucks heavier than 3.5 tons by the end of 2030). In addition, every year the total power output provided through recharging stations will increase as per the number of registered cars. For trucks above 3.5 tons there will be at least two recharging points in each parking area (by the end of 2027) and four (by the end of 2030).⁴²

For the maritime sector the alternative fuels infrastructure regulation introduces an obligation that at least 90% of container ships and passenger ships have access to shore-side electricity supply (for busiest seaports) with at least one installation providing shore-side electricity by 2030. Airports need to ensure electricity supply for all aircraft stands next to the terminal (by 2025) and for all remote stands (by 2030).⁴³

The above measures target stronger CO₂ standards and aim to contribute not only for decarbonization but also to bring benefits for EU citizens (through lower energy expenditure and better air quality). No less important, the policies will provide long-term signal to both the automotive sector's investments in innovative zero-emission technologies, as well as for recharging and refueling infrastructure.⁴⁴

- Purchase benefits and tax incentives for e-vehicles

Among the prerequisites for proliferation of electric vehicles is their differential taxation and incentives granted in comparison with ICEVs. Within this context, current EU taxation systems differ not only in their levels of taxation but also in terms of structure and principles.⁴⁵

Generally, the most significant attribute for an innovative taxation framework is the effectiveness to induce substitution of an undesired product (ICEVs running with polluting fossil fuels) to a more sustainable alternative (EVs on alternative fuels). Differentiated taxation may aim at accomplishing this goal by ensuring that the overall price of the innovative product (EVs) and the costs for its maintenance (including fuels) are at least similar or even lower than those for traditional products (ICEVs). Considering that currently the retail price of EVs is higher than the prices of ICEVs it is of importance that both EU car manufacturers and consumers are provided with tax benefits in the long term.⁴⁶

In terms of businesses, initiatives for promoting electric vehicles may be aimed at encouraging companies to adopt electric vehicles and reduce the carbon footprint of their fleets. The initiatives for personal use, on the other hand, may be aimed at making electric vehicles more

⁴² Ibid.

⁴³ Ibid.

⁴⁴ "Questions and Answers - Sustainable transport, infrastructure and fuels" accessed at:

https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3525 on 1 May 2023.

⁴⁵ Hauff, K.; Pfahl, S.; Degenkolb, R. Taxation of Electric Vehicles in Europe: A Methodology for Comparison. *World Electr. Veh. J.* 2018, p. 2.

⁴⁶ "Electric car costs to remain higher than traditional engines," *Financial Times* accessed at

<https://www.ft.com/content/a7e58ce7-4fab-424a-b1fa-f833ce948cb7> on 1 May 2023.

attractive to individual consumers and encouraging them to switch to electric vehicles for their personal transportation needs.⁴⁷

A 2022 study entitled “Electric vehicles: Tax benefits & purchase incentives” of the European Automobile Manufacturers’ Association (ACEA) concludes that while almost all EU member states offer some form of fiscal support to stimulate the market uptake of electric vehicles, both the nature and the monetary value of such tax benefits / incentives differ widely.⁴⁸

Among the key observations of the study are that:⁴⁹

- (i) As of 2022 there are twenty-one EU member states (four more than in 2021) that offer incentives for purchase of electric vehicles
- (ii) Six countries (four less than 2022) do not provide any purchase incentives with most of them merely granting tax reductions or exemptions for electric vehicles with Estonia being the only state without any fiscal stimuli.

Bulgaria is being listed among the countries not providing specific purchase incentives but exempting electric vehicles from ownership-related taxes.

The study itself differentiates between two main tax differentiation methods used within the EU, namely, tax benefits and purchase incentives. Tax benefits, in turn, are sub-divided into ones upon acquisition (e.g., VAT deduction and exemption in France, no excise duties for EVs in Croatia, exemption from registration taxes for zero-emission passenger cars and vans in Finland), for ownership taxes (e.g., exemption in Bulgaria and Croatia) and tax measures for company cars (e.g., exemption for battery electric vehicles and plug-in hybrids in Hungary, exemption from CO2-based taxes on components for vehicles emitting less than 60g CO2/km in France). On the other hand, purchase benefits relate to various bonuses, cashback initiatives, subsidies, discounts for acquisition and/or usage of EVs.⁵⁰

Other measures may include tax breaks, i.e., purchase, lease, road taxes being eased to make EVs a more attractive alternative to consumers. For example, in the Netherlands, the income tax addition for full electric lease cars is 0% in 2013 and 4% in 2014 (versus 14-20% for ICEVs). Specific benefits offered within EU cities may include use of special driving lanes, preferential or free parking, waiving of toll fees (e.g., in Paris EV owners enjoy reduced toll and parking fees).⁵¹

Acknowledging the existing lack of harmonized tax policies for EVs on EU-wide level, below we provide non-comprehensive examples on measures undertaken within several EU countries.

⁴⁷ International Council on Clean Transportation, “Charging infrastructure in cities: Metrics for evaluating future needs, accessed at <https://theicct.org/sites/default/files/publications/EV-charging-metrics-aug2020.pdf> on 15 May 2023.

⁴⁸ “Overview – Electric vehicles: tax benefits & purchase incentives in the European Union (2022)” by European Automobile Manufacturers’ Association accessed at: <https://www.acea.auto/fact/overview-electric-vehicles-tax-benefits-purchase-incentives-in-the-european-union-2022/> on 1 May 2023.

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ Hauff, K.; Pfahl, S.; Degenkolb, R. “Taxation of Electric Vehicles in Europe: A Methodology for Comparison”, World Electric Vehicle Journal, 2018, p. 17.

The Netherlands is among the EU countries with longest traditions in granting tax benefits and incentives for EVs. The amount of the Dutch motor vehicle tax is based on the emissions output. This means that only zero emissions cars, such as fully electric cars, are exempt from paying taxes. For cars that emit 1-50 grams of CO₂ (for instance plug-in hybrid electric vehicles) the user pays half of the tax rate. In line with its ambitious goals to increase the percentage of EVs to 50% of all sold passenger cars to 2025, the Dutch government considers adjusting the taxes (tariffs) for motor vehicles by using differentiation criteria as provided in the table below:

Motor vehicle tax Netherlands:⁵²

Motor vehicle tax Netherlands	2022-2024	2025	2026
EV* (0 g/km CO ₂)	Tax free	1/4 tariff	Full tariff
PHEV* (1-50g/km CO ₂)	1/2 tariff	3/4 tariff	Full tariff
Other hybrids (>50g/km CO ₂)	Full tariff	Full tariff	Full tariff
Regular vehicles	Full tariff	Full tariff	Full tariff
High emissions diesel van***	Full tariff + 15%	Full tariff + 15%	Full tariff + 15%

* Electric Vehicle
** Plug-in Hybrid Electric Vehicle
*** Private or business

In Germany there is no state-wide registration fee but instead a fee of about EUR 20-30 depending on the city. In June 2016 the country has introduced 3-year subsidies for purchases of certain vehicles (e.g., EUR 4,000 for battery electric vehicles and EUR 3,000 for plug-in hybrid EVs). In this case, half of the subsidy is paid by the government and the other half is paid by the car manufacturer.⁵³

In Italy taxation of vehicles generally depends on engine power with electric vehicles being exempt from paying vehicle taxes for 5 years from the date of their first registration. Following the end of the said period, the required payments include a fee equal to a quarter of the amount for gasoline vehicles.⁵⁴

As noted, Bulgaria is still among the EU states without specific tax policies related to EVs except for exempting such vehicles from ownership taxes. Nevertheless, in April 2023 the government introduced a proposal for public consultation regarding drafting of new Electric Mobility Promotion Act. The purpose of the new legislation would be to introduce incentives for market entry of EVs in line with “polluter pays” principle as well as special measures such as subsidies for zero-emission vehicles, differentiation of registration/ownership fees/taxes depending on the level of emissions and scrapping schemes for polluting vehicles.

⁵² “Motor vehicle tax (mrb)” accessed at: <https://business.gov.nl/regulation/motor-vehicle-tax/> on 1 May 2023.

⁵³ Hauff, K.; Pfahl, S.; Degenkolb, R. “Taxation of Electric Vehicles in Europe: A Methodology for Comparison,” World Electric Vehicle Journal, 2018, p. 2.

⁵⁴ Ibid.

Historically the EU legislative framework for energy products has been based on "economic" criteria which, as a primary objective, aim to ensure the proper functioning of the single market. This goal is to be achieved mainly through the setting of minimum taxation levels below which EU states are not allowed to tax energy products as well as specific taxation regimes, rules and rates for certain activities / sectors. The existing taxation is volume-based one and in practice favors polluting fossil fuels while providing little incentives for innovation toward more sustainable products.

The goals of the Green Deal and "Fit for 55" legislative package coupled with the increased usage of sustainable fuels has gradually shifted the EU energy taxation to environmental and sustainability goals which should support economic growth and development of the single EU market. This tendency is evidenced in the current proposal for new Energy Taxation Directive. The project shifts the focus to tax differentiation of energy products based on their harmful nature, externality (polluting effect), energy content and environmental performance.

Tax differentiation also plays an increasing role toward decarbonization of the transport sector and facilitation of eco-friendly vehicles including ones running on novel fuels such as electricity.

Section 2

Differentiated taxation of food and non-alcoholic beverages



Section 2:

Differentiated taxation of food and non-alcoholic beverages

In the current chapter we analyze policies of countries that have implemented taxes on food and non-alcoholic beverages for the purpose of improving public health and promoting healthy dietary habits. The differentiated taxation reviewed by us involves analysis based on the content of three types of substances (ingredients) with scientifically proven harmful effect on human health in case of excessive consumption, namely, sugar, saturated fats, and salt. The said ingredients are not subject to harmonized tax legislation on EU level. In this regard our comments concentrate on practices developed by several countries and aimed to impact consumers' behaviors.

I. Policies aimed at harm reduction and public health promotion

1. Global public health goals

During the last decades, both the WHO and the UN have developed a wide range of policies supporting national efforts for health improvement. Among the main measures for this purpose is the introduction of specific fiscal policies on national level. Thus, appropriately designed policies are deemed to entail considerable potential for promoting the prevention and reduction of behavioral risk factors that are, in turn, considered as a precondition to various noncommunicable diseases (NCDs).

The NCDs, also known as chronic diseases, are the result of a combination of genetic, physiological, environmental, and behavioral factors. The main types are cardiovascular diseases (such as heart attacks and stroke), cancers, chronic respiratory diseases (e.g., chronic obstructive pulmonary disease and asthma) and diabetes. The NCDs are important social development issue as they disproportionately affect people in low and middle-income countries, where more than three quarters of global deaths occur. According to the WHO, the NCDs kill 41 million people each year, equivalent to 74% of all deaths globally.⁵⁵

The WHO has endorsed a Global Action Plan (GAP) in support of key components from its global strategy for prevention of NCD. This action plan entails policy options for control of NCDs at local and global level. The GAP is focused on the reduction of the negative impact from four main types of NCDs: cardiovascular diseases, cancer, chronic respiratory diseases and diabetes.

⁵⁵ World Health Organization, "Noncommunicable diseases" accessed at: <https://www.who.int/news-room/fact-sheets/detail/noncommunicable-diseases> on 2 October 2022.

For this purpose, the GAP is primarily aimed at four behavioral risk factors, namely, tobacco use, physical inactivity, alcohol and unhealthy dietary habits.⁵⁶

The WHO further proposes that states undertake actions facilitating the use of economic tools (such as new taxes and subsidies) as a mechanism for provision of incentives toward positive behavioral impact aimed at healthier diets. The desirable behavioral shift is associated with improved health outcomes which are, *inter alia*, direct results from discouraging the consumption of unhealthy products.⁵⁷

2. Consumption of sugar, fats, and salt – health implications

The human consumption of sugar, fats, and salt dates from the ancient history of the humankind. These substances are often associated with specific beneficial aspects (e.g., improved taste of food) and have been an integral part of dietary habits across the world. From health perspective, the salt is essential for the fluid balance of the body, the sugar provides energy for the physical and mental activity, while the fats of various kinds make up the bulk of the human brain's mass.

Over time, however, their consumption has increased multiple times leading to negative health implications.⁵⁸

As early as the 1990s, having discovered the addictive properties of these ingredients, various manufacturers have started to increase their quantity in different types of foods and beverages. As an example, the current yearly sugar consumption in developed countries is between 68 - 77 kg per person, compared to approximately 1.8 - 2.7 kg consumed per year in the early 1700s.⁵⁹ Similar trend is observed for the salt with most people consuming approximately 9 - 12 grams per day, which is more than double the recommended maximum amount.⁶⁰

Currently there is a pronounced worldwide market demand and consumption of foods and soft drinks with high levels of salt, sugar, and saturated fats. This consumption, in turn, has a detrimental impact on global health as reflected in the increased levels of obesity and its comorbidities, diabetes and cardiovascular diseases.⁶¹

The overconsumption of such ingredients, along with the current food environment and the availability / marketing of foods and non-alcoholic beverages high in saturated fats, trans fats, sugars or salt is a major driver causing a significant global increase in obesity which contributes to the growing global burden of obesity-related diseases.⁶²

Problems associated with dietary habits and intake of harmful products are nowadays observed from early childhood making the overnutrition / malnutrition among the most important global health problems. Estimates in 2020 show that 38,9 million children under the age of 5 are

⁵⁶ WHO: *Global Action Plan for prevention and control of noncommunicable diseases 2013-2020*, p. 8.

⁵⁷ WHO: *Global Action Plan for prevention and control of noncommunicable diseases 2013-2020*, p. 11-18.

⁵⁸ *Science of food*, Raymond L. Rodriguez, Sharon P. Shoemaker: *Addressing the sugar, salt, and fat issue the science of food way*, 2018; p.1.

⁵⁹ *Ibid.*

⁶⁰ *Salt reduction*: <https://www.who.int/news-room/fact-sheets/detail/salt-reduction>; October 2022.

⁶¹ WHO: *Fiscal policies to promote healthy diets: policy brief*, 2022; p.1.

⁶² *Ibid.*

affected by obesity while 45 million by weight loss. In 2016 more than 340 million children and adolescents aged between 5 and 19 have been regarded as overweight or obese. In contrast, it is estimated that around 2.5 million deaths per year could be prevented by modest reductions of the salt intake.⁶³

Therefore, considering the growing problem related to overconsumption of salt, sugar and fats, the WHO and other health organizations have set out specific recommendations related to unhealthy food and beverages. In this regard, countries are implementing policies aimed at curbing the demand for unhealthy products and simultaneously changing consumers' behaviors. Among the policies adopted are fiscal ones involving the taxation of harmful ingredients and, more generally, products with harmful contents.⁶⁴

II. Fiscal policies toward harmful products and ingredients

Fiscal policies aiming to improve human diet are a key approach reducing the consumption of calorie-dense foods and addressing the problems of obesity and diabetes. There is an increasing amount of evidence that taxes and subsidies influence the purchasing habits and behavior of consumers. For example, appropriately designed taxes on sugar-sweetened beverages would likely result in (relatively) proportional reductions in their consumption, especially in case of increased retail prices. An additional health-related approach is the provision of subsidies for fresh fruits and vegetables reducing their prices, i.e., ensuring the availability of healthier and cheaper options. Specifically in terms of price changes, low-income consumers are usually most price-responsive, therefore, are likely to directly benefit in case of consumption shift toward healthier products (itself resulting from changes in the prices of food and beverages).⁶⁵

1. Rationale behind the policies

Due to their potential for controlling the market "flows," fiscal instruments are also used as means for reaching health targets. The introduction of the policies implies the creation of incentives for reducing dietary risk factors from NCDs and, at the same time, generate public revenues. In addition, the interventions are deemed as a mechanism to influence consumers' behaviors toward specific products at purchasing (retail sales) point. Consequently, by stimulating consumers to purchase healthier food and beverages, accordingly, to reduce the intake of unhealthy ones, fiscal instruments aim to change food and beverages consumption at individual and household level.⁶⁶

The interventions function more effectively through modifications of incentives related to the production of healthier foods and beverages. Hence, increasing the applicable taxes affects the retail price of certain product and decreases their demand by consumers. When applied simultaneously with increased taxation levels, subsidies or similar measures encouraging

⁶³ Science of food, Raymond L. Rodriguez, Sharon P. Shoemaker: *Addressing the sugar, salt, and fat issue the science of food way*, 2018; p.1.

⁶⁴ Salt reduction: <https://www.who.int/news-room/fact-sheets/detail/salt-reduction>; October 2022.

⁶⁵ WHO Fiscal policies for diet and prevention of noncommunicable diseases, p. 10-11.

⁶⁶ Ibid.

healthier goods may be decreasing their cost for consumers thus increasing the consumption of healthy food. Consequently, it is the combination of taxes and subsidies which may effectively act as stimuli for the food and beverages industry to improve the nutritional quality of their production.

Another potential benefit from the fiscal interventions is the generation of revenues and their designation for health promotion purposes (including information campaigns).

To summarize, the use of fiscal policies is regarded as a major component for a comprehensive strategy toward the promotion of healthier diet and the NCDs prevention.

2. Considerations for differentiated tax policies

- Price elasticity

The responsiveness of consumers to price changes (referred to as "price elasticity") is central in the design of taxes targeting health promotion. In the cases where consumers can easily find a substitute in the form of alternative products, their response to price increases will be higher.

Products with a more elastic demand provide better opportunities for policies aimed at substitution. On the downside, the demand for foods and beverages is not always elastic, namely, consumers may not be responsive to price changes if accustomed to usage of specific product and unwilling to amend their behavior. A low-price elasticity, in turn, makes the tax more likely to be passed on to consumers by retailers, i.e., prices will increase at the point of consumption but the consumption itself will not decrease.

- Substitution effect

The size of the substitution effect generally depends on the extent to which there are available substitutes (e.g., for switching from sugar-sweetened beverages to water, milk, unsweetened 100% fruit juice, beverages with non-caloric sugar substitutes, like sweeteners). Close substitutes, therefore, enable larger substitution effects. The health effect depends on the extent to which consumers are able, or willing, to change their behavior.

From perspective of the consumers' socioeconomic status, low-income buyers, young people, and those most at risk of obesity are generally most responsive to changes in the prices of the foods and beverages.⁶⁷ Hence, well-designed taxes should enable the transfer from unhealthy or most harmful products to healthier or less harmful substitutes as a result of behavioral changes, related to product choice.

- Tax base and rate

The tax base should be preferably designed in a manner aiming to prevent "undesirable" substitutions (e.g., with other hazardous products) but instead steer substitutions towards healthier / less harmful alternatives. As noted, this effect may be pursued with the simultaneous application of "positive" fiscal incentives such as ones stimulating the production and

⁶⁷ WHO: *Fiscal policies for diet and prevention of noncommunicable diseases*, p.20.

consumption of less harmful products. The choice of a suitable tax base could minimize the potential adverse unexpected health effects of food and beverage taxes.⁶⁸

Another important aspect of the fiscal policies concerns the determination of the tax rate. The latter should be set in a manner allowing the tax to meet its purpose of reducing the consumption of the taxed products (and not simply increase their retail prices) which is not always a straightforward task.

3. Tax design

In terms of tax design, taxes on consumption (e.g., excise, VAT) are the most common taxation tool applied in the pursuit of public health goals. Some indicative aspects relevant for a proper tax design are:

- Nature of the tax (e.g., indirect tax on consumption)
- Foods/ingredients targeted by the tax
- Criteria for taxation such as tax base
- Applicable tax rate
- Taxable person(s) and method for accrual of the tax
- Tax collection
- Expected health and revenue outcome from the fiscal intervention etc.

Excise duty or a similar tax is easy to collect from practical perspective as it is typically due upon single and final stage of the supply chain (usually the purchase on behalf of the final consumer). Due to its one-off nature, the tax burden affects the tax base of the final product resulting in increase of the sales price. Such taxation mechanism implies lower administrative costs and mitigates the risk from tax evasion.⁶⁹

Depending on the taxable base, the tax may be:

- (i) specific - duty based on the content of the harmful ingredient within the final product (e.g., specific monetary value per teaspoon of added caloric sweetener)
- (ii) unitary (volume) - tax based on the volume of a final product (e.g., specific monetary value per kilogram of sweets)
- (iii) ad valorem (proportional) - levied as a proportion (percentage) on the retail/sales price of the product.⁷⁰

It is also possible to have a combination of the above.

Specific taxes may entail the benefit of directly “targeting” the harmful component. Consequently, they impose higher tax burden on each additional unit of harmful content thus increasing the prices of the most harmful foods and beverages. This effect, on the one hand,

⁶⁸ Jody C. Hoenink, Wilma E. Waterlander, Joreintje D. Mackenbach, Cliona Ni Mhurchu, Nick Wilson, Joline W. J. Beulens & Nhung Nghiem. *Impact of taxes on purchases of close substitute foods: analysis of cross-price elasticities using data from a randomized experiment.*

⁶⁹ Ibid.

⁷⁰ A typology of beverage taxation: multiple approaches for obesity prevention and obesity prevention-related revenue generation. *J Public Health Policy*, 2013; 34:403-423.

discourages their consumption and, on the other hand, encourages the production of foods and beverages with lower percentage / volume of the harmful ingredient. Therefore, the specific taxes are means for reduction of relative price gaps when imposed or increased, making it less likely that consumers substitute down to cheaper and less healthy options in response to tax increases (which is typically the effect of *ad valorem* taxes). To prevent the impact of specific taxes from being eroded over time, it is necessary that they are adjusted regularly to keep pace with inflation and reduce affordability of the taxed product by accounting for income growth.⁷¹

The unitary (volume) tax may be imposed in cases where, for example, it is easier to tax any resulting products containing the harmful content instead of the harmful content itself (e.g., liters of sugar-sweetened beverages).

Ad valorem tax may be regarded as more “flexible” in responding to the level of the inflation. However, these taxes do not provide for a direct link with the harmful content and may even encourage increased production and consumption of cheaper and lower-quality products thus, as a result, attracting less tax and missing their health objectives.

The inclusion of the excise tax in the taxable base may attract higher amount of VAT (assuming that the excise is included within the VAT base) thus further increasing the retail prices. The sole imposition of VAT, however, is unlikely to achieve health effects as it is a general tax on consumption levied on all products (unless a specific reduced rate applies) and is *ad valorem* by its nature.

Having said this, reduced VAT rates may be applied to “distinguish” between, for example, “general” food and beverages vis-à-vis specific “unhealthy” ones. An example for this is the list as per Annex III of Directive 2006/112/EC regarding possible goods and services to which Member States may apply reduced VAT rates. The possibilities, *inter alia*, involve water and foodstuffs (including beverages) for human and animal consumption, live animals, seeds, plants, ingredients normally intended for use in the preparation of foodstuffs as well as products used to supplement foodstuffs or as a substitute for foodstuffs. The reduced VAT rates, however, explicitly exclude alcoholic beverages. We also note that currently the Bulgarian VAT legislation provides for reduced 9% VAT rate on bread and flour (until July 2023) but this measure is rather aimed to counter the economic effects from high inflation and does not entail health implications.

An effective taxation approach may rely on a combination of taxes and subsidies as a mechanism to reduce potential substitution with other unhealthy foods or beverages. The most accurate and effective objectives for price policies would focus on their “upstream” potential to influence purchasing and consumption behavior, rather than on “downstream” effects, such as body weight or disease, which are influenced by a multitude of factors. In addition, regular monitoring and evaluation are necessary to highlight the relevant health outcomes of the tax implementation, while identifying potential unanticipated effects.⁷²

⁷¹ A typology of beverage taxation: multiple approaches for obesity prevention and obesity prevention-related revenue generation. *J Public Health Policy*, 2013; 34:403-423.

⁷² Anne Marie Thow, Peter Heywood, Stephen Leeder and Lee Burns, Menzies Centre for Health Policy, Victor Coppleson Building, University of Sydney, Sydney, NSW 2006, Australia: Department of International Health,

III. Differentiated taxation of food and non-alcoholic beverages (examples)

Considering the non-harmonized application of the taxes on unhealthy food and non-alcoholic beverages, in the current section we outline several examples for such policies from different countries across the world.

1. Sugar

- Finland

Finland is a country with a long history of fiscal policies targeting unhealthy lifestyles and consumption of harmful products including such with excessive sugar content. The policies involve a combination of higher taxation on risk-entailing goods and provision of subsidies on healthier products.

In 2011, the country imposed duties on sweets, chocolates, and soft drinks (Law 1127/2010). The motives for the introduction of the tax included both collecting higher public revenues and altering the consumption of food and drink towards healthier choices.⁷³ The applicable tax rates have been increased in two stages in 2012 and 2014, with the current rate being EUR 0,95 per kilogram of sweets and ice cream.

For non-alcoholic beverages, the tax imposed is EUR 0,11 per liter, while for beverages with more than 0,5% sugar content the amount to be paid is EUR 0,22 per liter. Products are identified by their CN heading/customs tariff code with specific exemptions (such as for small producers and exporters).⁷⁴

The specific taxation measures have generally contributed to reduced sales and consumption of soft drinks and sweets in Finland. Since the introduction of the "sweet" tax, overall demand has declined mostly for ice cream and soft drinks with a less pronounced impact on confectionery.⁷⁵

Aside from its positive consumption effects, several Finnish tax studies have noted that such a form of taxation entails downsides including ones related to possible product discrimination and distortion of competition. These concerns are based on opinions by Finnish producers in terms of decreased predictability as to whether their products will ultimately be taxed itself impeding proper business planning.⁷⁶

University of Sydney, Sydney, Australia: Department of Taxation Law, Sydney Law School, University of Sydney, Sydney, Australia. The global context for public health nutrition taxation.

⁷³ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector Annexes to the Main report, 2014*, p. 187-p. 197.

⁷⁴ WHO: *Fiscal Policies for Diet and Prevention of Noncommunicable Diseases*; p. 15.

⁷⁵ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector Annexes to the Main report, 2014*, p. 200.

⁷⁶ Ibid., at p.201.

Irrespective of the above, the implemented tax policy has generally succeeded in achieving revenues but also has also contributed to a reduction in the consumption of sweetened products thus having a beneficial effect on public health.⁷⁷

- France

Similarly, France applies a tax policy whereby the taxation of sweetened and unsweetened soft drinks is based on their CN (tariff) codes. The scope of the measures has been extended from including only carbonated beverages to any beverages with added sugar or sweeteners (including "light drinks").

From its onset, the tax has been regarded by French policymakers as an instrument for achieving economic and health objectives. To a certain extent, this notion is based on the fact that, on the one hand, the non-alcoholic beverage industry is a profitable one while, on the other hand, it is not as closely "linked" to the country's heritage or cultural traits as other industries (for example, wine production). From health perspective, an underlying factor for the introduction of the tax policy is its perception as an effective way to combat obesity.⁷⁸

Considering the above, in 2011, France adopted a charge with a contribution rate initially set at EUR 7,16 per hectoliter which in 2015, was subsequently increased to EUR 7,5 per hectoliter.⁷⁹ As a result of the measures, the revenue collected from the imposed policy amounts to approximately EUR 300 million as of 2013 with the collected amounts being distributed to the French National Health Insurance Fund.⁸⁰

Subsequent studies evaluating the impact of the measures show a positive effect in terms of public health and acceptance by the French consumers. The main beneficial outcome is the decreased consumption of carbonated beverages among young people, low-income groups and households with adolescents.⁸¹ According to certain reports, the perception of the implemented tax policy among the public is determined by the respondent's socio-economic status and educational level. The studies also found that the overall support increases when the tax policy is coupled with reduction in prices of healthier foods (e.g., through retail discounts) and when there is an awareness that revenues are allocated to the country's health care system.⁸²

Another interesting result from the implementation of the levy is that the possibility for substitution with other unhealthy products is limited due to the broad scope of the French tax, i.e., consumers cannot easily switch to similar products that are not taxed. This is because such products mainly involve "pure" juices.⁸³

⁷⁷ Ibid., at p.201.

⁷⁸ Yann Le Bodo, Fabrice Etilé, Chantal Julia, Marine Friant-Perrot, Eric Breton, Sébastien Lecocq, Christine Boizot-Szantai, Céline Bergeran, Françoise Jabot: *Public health lessons from the French 2012 soda tax and insights on the modifications enacted in 2018, 2022*; p.587.

⁷⁹ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p. 18.

⁸⁰ WHO: *Fiscal Policies for Diet and Prevention of Noncommunicable Diseases*; p.15.

⁸¹ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p. 22-26.

⁸² *Public health lessons from the French 2012 soda tax and insights on the modifications enacted in 2018, 2022*; p.586.

⁸³ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p. 37.

Observations of public attitudes led to changes in 2018 in the way for taxation of carbonated beverages. Following the amendments, the tax is linearly indexed to the amount of added sugars in the drink and, for this reason, is deemed as better aligned with the public health objectives.⁸⁴ Subsequent studies have shown that, because of the changes, producers themselves are going through a process of "adaptation" to the tax including in terms of product content reformulation. The scope of such reformulation varies between firms and is determined not only by production cost constraints and consumer attachment to specific beverage but also by the producer's brand, competitive position and relationships with distributors and bottlers.⁸⁵

- Mexico

Mexico is among the countries with highest consumption of sweetened products and beverages in the world. In 2012, it is named as the country with the highest consumption level of such products in the world, i.e., 160 liters per capita, with 71% from sugar-sweetened beverages (SSBs) and 23% from non-essential energy dense foods. As a result of the widespread consumption, the level of obesity in Mexico has reached 71% among adults and 30% in children and adolescents.⁸⁶

To address these adverse implications, in 2014, the Mexican government proposed measures for taxing SSBs through two types of taxes.

The first one is essentially an excise duty of 1 peso per liter on any soft drink with added sugar (powdered, concentrated or ready-to-drink) payable by the producer. The second one is 8% *ad valorem* tax on the prices of several categories of high energy foods that contain 275 calories per 100 grams or more (snacks, confectionery, chocolate, other products derived from cocoa, puddings, cakes, ice cream, candy, peanut butter). This tax is paid by the manufacturer or the retailer.⁸⁷

The adoption of the said policies initially sparks a negative response on behalf of Mexican manufacturers with the main concerns related to business uncertainty and negative financial impact from lost revenues.⁸⁸

Studies by the National Institute of Public Health of Mexico and the University of North Carolina, USA have concluded that, within one year, the policy leads to an average of 6% reduction in the purchases of the taxed products while, by the end of 2014, this drop increased up to 12%. The reduction in consumption was most pronounced among households of low socioeconomic status, averaging 9% decline in 2014 and up to a 17% by December 2014.⁸⁹

Moreover, additional observations on the impact of the policies have shown that in the years following the imposition of the tax, the decline in consumption of the taxed products for

⁸⁴ *Public health lessons from the French 2012 soda tax and insights on the modifications enacted in 2018*, 2022:p.588.

⁸⁵ *Ibid.*, at p.587.

⁸⁶ WHO: *Fiscal policies for diet and prevention of noncommunicable diseases*, p.16.

⁸⁷ Maria-Eugenia Bonilla-Chacin, Roberto Iglesias, Agustina Suaya, Claudia Macías, *Learning from the Mexican experience with taxes on sugar-sweetened beverages and energy-dense foods of low nutritional value*, p. 9-11.

⁸⁸ PAN American Health Organization and WHO: *Taxes on Sugar- sweetened Beverages as a Public Health Strategy: The Experience of Mexico*; p.48.

⁸⁹ *Ibid.*

households located in urban areas has reached 78%. This trend is coupled with a higher demand for bottled water with an increase of 16. 2%. However, unlike the results in cities, the impact in rural areas is rather negligible. The studies put forward various hypotheses for this phenomenon, i.e., from difficult access to bottled water in remote regions to failed adoption of the tax policy in specific provinces.⁹⁰

2. Saturated fats

- Denmark

An example for implementation of fiscal policies toward saturated fats is Denmark. The Danish "saturated fat tax" is introduced in 2011 with the main goal to influence the dietary habits of consumers.⁹¹ The tax covers saturated fats in meat, full-fat dairy products, animal fats, edible oils, margarine and similar. The aim of the levy is to encourage consumption to products with lower saturated fat content such as low-fat cheese (instead of full-fat one).⁹²

The introduction of the tax turned out to be controversial and its implementation was coupled with a negative response from the food industry, retailers and even health experts who expressed doubts about its effectiveness in terms of public health.⁹³ The criticisms of the tax involve arguments regarding the level of harm from saturated fats when taking into account their possible "replacement" by other harmful foods and substances (as opposed to healthier fatty acids and low-fat foods).⁹⁴ In addition to this, Danish farmers and retailers raised concerns about possible increase in cross-border purchases from neighboring states thus reducing the revenues for local producers, imposing a heavy administrative burden on the Danish industries and encouraging the relocation of jobs abroad.⁹⁵

Irrespective of the above, several studies indicate a positive trend in the demand for such products. Following the introduction of the tax on saturated fats, a decline in demand is observed, with a decrease in 2012 by 5,5% for cooking oils, 5,5% for butter and 8,2% for margarine. The said decline in consumption, however, is proportionally smaller compared to the increase in prices, which is considered as a sign of a slight market inelasticity.⁹⁶

Observations on the implemented tax policy in Denmark indicate that it leads to 10-15% reduction in the level of fats consumed by the relevant product categories (butter, margarine, and blends). In contrast, the demand for lower-tax products, whose prices are less impacted, has increased (e.g., in 2012 the increase for olive oil is 6,3% and for vegetable oils 3,2%).⁹⁷

⁹⁰ The Journal of Nutrition Nutritional Epidemiology: After Mexico Implemented a Tax, Purchases of Sugar-Sweetened Beverages Decreased and Water Increased: *Difference by Place of Residence, Household Composition, and Income Level*, 2014; p. 3-4.

⁹¹ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; Table 1.2, p. 17.

⁹² Ibid., at p.40.

⁹³ European Journal of Clinical Nutrition: *The Danish tax on saturated fat: why it did not survive*, 2014; p.224-225

⁹⁴ Ibid., at pp.224-225.

⁹⁵ Ibid., at p.225.

⁹⁶ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p.35

⁹⁷ Ibid., at p.35.

Irrespective of the positive observations in terms of consumption trends, following the controversies, the saturated fat tax is abolished as of the beginning of 2013.⁹⁸

Aside from the generally negative publicity, several studies reveal that the impact of the tax continues even after its abolition. The main positive effect is the persisting effect in terms of consumers' preferences to certain goods. In this relation, the demand for the targeted product categories in Denmark does not regain its pre-tax levels and continues to be below the proportional changes in their prices. Consequently, the conclusions made by certain researchers is that Danish consumers who have already switched to lower-fat and lower-taxed foods do not alter their behavior to higher-fat goods even after the tax is abolished.⁹⁹ Taking this circumstance into account, the studies conclude that the main effect achieved by the Danish tax on saturated fats is related to a decrease in the demand for products with a higher saturated fat content and a switch to cheaper versions of the taxed products or to entirely tax-free products.¹⁰⁰

At the same time, the controversy surrounding the tax and its abolishment indicate some of the problems inherent in the introduction of tax policies regarding food and beverages. Such controversies include, *inter alia*, presumed negative economic impact for specific industries, trade obstacles for certain products and disputed health implications due to potential "harmful" substitutions.

3. Salt

- Hungary

Hungary is among the countries that have introduced tax measures on salty products. The main objective of the tax is to reduce the harmful intake of food products with high content of salt.. In addition, the levy aims to encourage healthier eating habits among Hungarian consumers coupled with increased revenues for public health services.¹⁰¹

The adopted duty covers ready-to-eat foods and beverages with a high content of salt with other targeted ingredients involving sugar and caffeine. The tax rates depend on the category of the respective product while the revenue from the tax is allocated to the public health budget.

The introduction of the tax is opposed by Hungarian food industry while being supported by various health organizations and health workers.¹⁰² Following post-implementation studies, it is considered that this tax has influenced the habits of Hungarian consumers, with data showing that purchases of taxed products decrease by approximately 27%. Based on country surveys, it is estimated that 16% of salty snack consumers have changed and reduced their consumption, with the main cited reason being the increased prices.¹⁰³

⁹⁸ European Journal of Clinical Nutrition: *The Danish tax on saturated fat: why it did not survive*, 2014; p.224-225

⁹⁹ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p.40.

¹⁰⁰ *Ibid.*, at p.23-24.

¹⁰¹ Alison Giles, Danielle Costigan, Hannah Graff, Rebecca Stacey and Modi Mwatsama: Case study: *The Hungarian public health product tax*, 2019; p.7-8.

¹⁰² *Ibid.*, at p.9.

¹⁰³ WHO: *Fiscal policies to promote healthy diets: policy brief*, 2022; p. 15.

In addition to the impact on consumption, the tax influences business activities of Hungarian manufacturers prompting them to change the composition of their products, for example, by completely removing or significantly reducing the taxable ingredient. According to one of the studies *"40% of manufacturers changed their recipe, 30% of them completely removed the target ingredient, and 70% of them reduced the amount of the target ingredient."*¹⁰⁴

Furthermore, the introduction of the Hungarian levy on public health products has contributed to a decline in the consumption of almost all product groups in the savory snack market. Based on six-months data *"the level of decline ranges between 15% and 15%-25% in some segments. The consumption of chips decreased by 15,4%; this decrease was 22,2% for nuts and 15,3% for flour products (salt sticks, sausages, chips, etc.)."*¹⁰⁵ The tax, therefore, is considered to contribute to "healthier" composition of the targeted products and, specifically, changes in the consumption of those products containing harmful amounts of salt.¹⁰⁶

Another positive impact that has been observed is the amount of revenues collected which, during the initial four years of implementation, amount to HUF 61.3 billion (about USD 219 million) and are subsequently allocated to public healthcare services.¹⁰⁷

In terms of food and non-alcoholic beverages, it is usually a specific content (ingredient) that is subject to differentiated taxation. Examples of such ingredients are sugar, saturated fats, and salt. The taxation of these substances is not regulated by harmonized rules, therefore, different states adopt country-specific approaches.

The taxation is usually performed through a tax entailing the specifics of an excise duty such as being one-off (not cumulative), indirect and levied on the stage of final consumption. The main goal of the tax is to discourage/decrease the consumers' usage of products containing high volume/level of the specific harmful substance. In addition, the tax is influencing the incentives for producers to switch to products with altered content and presumably healthier nutritional composition.

However, as evidenced by the Danish tax on saturated fats, the imposition of health taxes is prone to criticism for possibly entailing discrimination against certain products, distortion of competition as well as potential substitution on behalf of consumers with other "harmful" products.

¹⁰⁴ ECORYS: *Food taxes and their impact on competitiveness in the agri-food sector (Final report)*, 2014; p. 33.

¹⁰⁵ Ibid., at p.38.

¹⁰⁶ WHO: *Using price policies to promote healthier diets*, 2015; p.21.

¹⁰⁷ Alison Giles, Danielle Costigan, Hannah Graff, Rebecca Stacey and Modi Mwatsama: *Case study: The Hungarian public health product tax*, 2019; p.15-16.



Section 3:
*Differentiated taxation of alcoholic
beverages*

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Differentiated taxation of alcoholic beverages

In the current chapter we analyze the main policies and criteria applied for the differentiated taxation of alcoholic beverages. The said beverages are subject to EU-wide harmonized legislative framework and tax (excise duty). The topic is analyzed from the perspective of the general taxation methods used for alcoholic beverages. The focus is on the EU-wide excise legislation based on historic tax differentiation between several major categories of products. Finally, we are drawing a parallel with the 2021 initiative in the United Kingdom for introduction of a new alcohol duty system based on alcohol content.

I. Main taxation principles

1. Alcoholic beverages - economic, health and social considerations

The production and consumption of alcohol has accompanied the human development for thousands of years. Specific regions and countries from the world have developed distinctive methods for production of alcoholic beverages which have become not only an important part of their economic development but have gradually turned into signature cultural features ("national" drinks such as sake for Japan, moutai for China, ouzo for Greece). Today, alcohol production is an important sector within the food and beverages industry with an impact on many other industries (retail sales, travel, tourism, restaurant services).

The consumption of alcohol and specifically the excessive use, however, has its "reverse" side. According to the 2010 draft "Global strategy to reduce the harmful use of alcohol" of the WHO, the abuse of alcohol has a serious effect on public health and is one of the main risk factors for dangerous societal behaviors (aggression, road accidents and suicidal trends). Excessive drinking is the cause behind detrimental health and social consequences for the consumer, the people around the consumer and for the society by leading to patterns of drinking associated with high risk of adverse health and public outcomes. The harmful use of alcohol, therefore, impacts both the individual health and the social environment.

Alcoholic beverages are significant "contributors" to the global burden of diseases such as neuropsychiatric disorders and noncommunicable diseases including cardiovascular ones, cirrhosis of the liver and various other cancers, as well as diabetes. The abuse of alcohol is also a social development issue as the level of risks from the harmful use is much higher in developing and low-income countries than in high-income states.¹⁰⁸

¹⁰⁸ "Global strategy to reduce the harmful use of alcohol", World Health Organization, p. 3 - 7.

2. Alcohol – product characteristics

“Pure alcohol” (also referred to under its chemical name “ethanol”) constitutes a psychoactive drug that is the active ingredient in drinks such as beer, wine and distilled spirits.¹⁰⁹ The alcohol by volume (ABV) is the standard measure of the amount of alcohol (ethanol) contained in a given volume of alcoholic beverage (expressed as a volume percent). It is defined as the number of milliliters (mL) of pure ethanol present in 100 ml (3.5 imp fl oz; 3.4 US fl oz) of solution at 20 °C (68 °F).¹¹⁰

Alcoholic beverages, in turn, are liquids that contain alcohol/ethanol and are intended for drinking. Most countries globally have introduced legal definitions for such beverages referencing to a minimum threshold for ethanol content by volume around 0.5% or 1%.¹¹¹

Considering the above, it seems logical that the taxation on alcohol and alcoholic beverages is based on the pure alcohol content or alcohol by volume (ABV) of the product. Such taxation, in addition, seems logical from public health perspective, i.e., products with higher ABV are presumably more detrimental for the health, therefore, are to be taxed with higher rates if compared with goods with lower ABV. However, history and traditions have made it difficult to follow such a straightforward approach.¹¹²

3. Differentiation – basic tax categories of alcoholic beverages in the EU

The European Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages (“Alcohol Structures” Directive) is based on historically developed distinctions between five main types of drinks, as follows:

- Beer
- Wine (still and sparkling)
- Other fermented beverages (“OFB”) different than beer and wine
- Intermediate products
- Strong alcoholic beverages (ethyl alcohol).

Similar distinctions between the tax categories are followed by other states worldwide.

According to the European Commission, by establishing different categories of products, the Alcohol Structure Directive acknowledges the clear and explicit intention of the legislator to create the possibility for Member States to apply differentiated excise duties on the abovementioned categories when pursuing national policies for alcohol taxation.¹¹³

In this regard, while higher content/concentration of ethyl alcohol (ethanol) is generally taxed more heavily, most Member States apply taxation policies setting different excise rates for the different categories (rather than pursuing policies of equivalent taxation based on ABV). The

¹⁰⁹ [https://en.wikipedia.org/wiki/Alcohol_\(drug\)](https://en.wikipedia.org/wiki/Alcohol_(drug)); accessed on 7 September 2022.

¹¹⁰ https://en.wikipedia.org/wiki/Alcohol_by_volume; accessed on 7 September 2022.

¹¹¹ “Global strategy to reduce the harmful use of alcohol,” WHO, p. 5.

¹¹² “Introduction to the European Excises (2008/118/EC)”, B. Terra, J. Kajus & H. Winkels, Global Topics IBFD, p. 83.

¹¹³ Case Study Report – Classification “Evaluation of Council Directive 92/83/EEC”, May 2016, European Commission, p. 2 - 3.

pursuit of preferential tax regimes is usually based on the goal to preserve specific socio-cultural aspects (e.g., continuous production and consumption of traditional products made from natural ingredients grown in a particular location) and/or support the generation or preservation of jobs, practices and traditional crafts usually related to one or more of the alcohol categories.¹¹⁴

4. Impact of pricing policies on alcohol consumption

Among the areas for policy options and interventions outlined by the WHO for addressing the harmful alcohol usage are pricing policies for alcoholic beverages. The WHO points that consumers, including heavy drinkers and young people, are sensitive to increases in the prices of drinks. The pricing policies, therefore, can be used to reduce underage drinking, halt progression towards drinking large volumes of alcohol and influence consumers' preferences and behavior. Some of the interventions within this area according to the WHO should include:

- establishing a system for specific domestic taxation on alcohol based on the alcoholic content (ABV) of the beverage
- regularly reviewing rates in relation to the level of inflation
- restricting the use of direct and indirect price promotions, discount sales, sales below cost and flat rates for unlimited drinking or other types of volume sales
- establishing minimum prices for alcohol
- providing price incentives for non-alcoholic beverages.

The main way to achieve such pricing policies, according to the WHO, is through taxation of alcoholic beverages.¹¹⁵ The WHO notes that the predominant conclusion from various studies is that taxation policies are generally an effective strategy for alcohol harm reduction.¹¹⁶ Hence, policy measures increasing cost of alcohol are an effective tool for reducing alcohol consumption. The WHO considers that alcohol taxation and pricing policies have several public health, economic and social benefits as they have the capacity to: (i) generate tax revenue, (i) reduce alcohol consumption and associated harms among various groups including young people and heavy drinkers and (iii) prevent initiation of drinking.¹¹⁷

5. Types of taxes on alcohol

Alcohol taxation is performed mostly through taxes assessed on consumption which are generally indirect ones. The three main taxes related to alcoholic beverages are:¹¹⁸

- customs duties
- VAT (general tax on consumption)
- excise tax (duty).

¹¹⁴ Ibid, p. 2.

¹¹⁵ "Alcohol pricing in the WHO European Region - update report on the evidence and recommended policy actions", World Health Organization, executive summary.

¹¹⁶ "Alcohol pricing in the WHO European Region - update report on the evidence and recommended policy actions", World Health Organization, p. 3.

¹¹⁷ Resource tool on alcohol taxation and pricing policies, Editors: Bundit Sornpaisarn, Kevin D. Shield, Esa Österberg, Jürgen Rehm; World Health Organization, executive summary.

¹¹⁸ Ibid, p. 26.

Customs duties are levied on specific imported goods and create a barrier to protect similar domestically produced goods. General tax on consumption (VAT) is imposed on all or almost all goods and services. Excise tax is imposed on specific goods such as ones considered to generate negative externalities (e.g., alcoholic beverages, tobacco).

An increased customs duty would affect imported alcohol but would not influence the domestically produced goods so it is unlikely to have net positive impact on overall alcohol consumption.

The VAT may be used as a tool for tax differentiation purposes especially in terms of the applied VAT rates. For example, the VAT rate for alcohol (including when served in restaurants and similar establishments) may be higher from that applied to other types of foods and beverages. A similar effect is achieved if alcoholic beverages are subject to a "general" VAT rate and no reduced rate applies to them. Such an approach is currently provided for in the Bulgarian VAT legislation which includes temporarily reduced 9% VAT on restaurant and catering services including home food (as of the date of the analysis this measure applies until 31 December 2023). The reduced VAT rate, however, does not cover beer, wine and spirits which are subject to 20% VAT.

From the three types of taxes, excise duties are considered by the WHO as the optimal tool to directly influence alcohol consumption and its related harms because these impact both domestic and imported alcohol without being assessed on other types of beverages.¹¹⁹

6. Approaches to excise taxation of alcohol

The system of taxation with excise duty would lead to different effects depending on the logic behind the adopted approach. Three main approaches to excise taxation are differentiated in this relation (with a fourth one as combination of the others):¹²⁰

- A. Specific taxation - duty levied based on alcohol content of a product with the tax base being the amount of ethanol in the alcoholic beverage; within the EU specific taxation is predominantly applied to beer and spirits (ethyl alcohol)
- B. Unitary (volume) taxation - tax assessed on the volume of a product with the tax base being the volume of the beverage; within the EU this taxation is applied to wine, intermediate products and OFB
- C. *Ad valorem* taxation - duty levied on the sales price of a product with the tax base being the price of the beverage
- D. Hybrid taxation - combination of the above.

The WHO argues that in terms of the relative effectiveness of these approaches at reducing alcohol consumption the evidence is strongest for the specific taxation approach. Conversely, tax systems based on either unitary or *ad valorem* taxation may encourage the manufacture of stronger products, potentially increasing alcohol consumption as a result.

¹¹⁹ Ibid.

¹²⁰ Ibid., pp. 32 – 36.

The reason for this is that a system of specific taxation means that the tax levied on each gram of ethanol is the same and, therefore, a bottle of wine at 15% alcohol by volume (ABV) will attract a greater level of duty than a bottle at 12% ABV. Under the specific taxation, the tax due depends on the ethanol content, therefore, it discourages the production of high ethanol content beverages and encourages the production of low ethanol ones that are of relatively higher quality ("upgrading effect").¹²¹

By contrast, under unitary system, same products with different ABV would attract the same duty, meaning that the duty levied per gram of ethanol falls as product strength increases. The unitary taxation levies beverage volume but not the alcohol content or perceived quality. The alcohol producers may adjust their products by increasing the ethanol content to reduce the tax burden per unit of ethanol. Thus, unitary taxation encourages producers to manufacture alcoholic beverages that have a high ethanol content. Having said this, this system currently remains preferred for alcoholic beverages for which it is difficult to determine the exact ethanol concentration, such as wine.¹²²

Under ad valorem system, there is no direct link between alcohol content and the duty. This means that high-strength products with low production costs can be sold to consumers at cheaper prices than lower-strength products that cost more to produce, as they attract less tax.¹²³ Ad valorem taxation taxes both ethanol and perceived qualities. It thus encourages producers to manufacture low-quality alcoholic beverages by reducing the value of the unnecessary perceived qualities (such as reducing the brewing period or the quality of packaging) to decrease the price and tax burden per unit of ethanol ("downgrading effect"). This taxation also encourages producers toward high ethanol content beverages in order to decrease the value of the perceived qualities per unit of ethanol. Hence, this taxation may lead to production and sale of high ethanol content beverages and perceived low-quality beverages resulting in a lower beverage price.¹²⁴

The report of the WHO on alcohol pricing indicates that many countries in the European region (comprising in total 53 states including EU members) do not implement a fully specific system of alcohol taxation which may be optimal from the perspective of public health. One such example is the European Union where the relevant directives require that wine and other products such as ciders are taxed on unitary/volume basis.¹²⁵

Among the main observations of the WHO is that there is no clear argument from a health perspective to tax different products on different bases. As alcohol itself is the factor of harm, the most effective approach to taxation with a view to improving public health and reducing the harm, according to the WHO, is to tax the volume of alcohol directly through a fully specific system of taxation. The key policy recommendation of the WHO for the excise taxation is,

¹²¹ Resource tool on alcohol taxation and pricing policies, WHO, p. 33.

¹²² Ibid., p. 34.

¹²³ "Alcohol pricing in the WHO European Region - update report on the evidence and recommended policy actions", World Health Organization, pp. 3 - 4.

¹²⁴ Resource tool on alcohol taxation and pricing policies, WHO, p. 33 - 34.

¹²⁵ "Alcohol pricing in the WHO European Region - update report on the evidence and recommended policy actions", World Health Organization, pp. 3 - 4.

therefore, that the levies are on a specific basis.¹²⁶ Consequently, it may be concluded that from public health perspective the WHO deems the ABV content as a recommended common denominator for taxing all alcoholic beverages irrespective of their tax category.

As indicated, however, the EU excise legislation is not solely based on the ABV criterion and it is unlikely that such an approach will be adopted in the near future. The main reason for this is the simultaneous recognition of the product differentiation as a major factor for taxation. In this regard we note that taxation solely based on ABV content may result in favoring one existing tax category of drinks over another thus further stimulating one alcohol production sector over others leading to economic disruptions.

For example, the production of beer will most likely be in a more favorable taxation position for excise than the production of wines thus “reversing” the historically privileged position of the EU wine-producing sector. Furthermore, taxation solely based on alcohol content may mitigate the incentives for producing high-quality drinks of higher ABV.

II. EU excise rules regarding alcohol

In addition to the Alcohol Structures Directive, the other two main EU regulatory acts in the area of the excise duty are Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages (“Alcohol Rates Directive”) and Directive (EU) 2020/1151 of 29 July 2020 amending the Alcohol Structures Directive.

1. Classification of alcoholic beverages

For excise taxation purposes, the alcoholic beverages are distinguished based on two main criteria: (i) tariff code and (ii) alcohol content. These criteria are further taken into account when allocating certain product to one of the five tax categories.

In this regard, the products subject to excise taxation are identified by their classification code for customs purposes. It should be noted, however, that the excise categories of beverages do not completely overlap with “customs” codes (i.e., products under same headings but different subheadings may fall within different excise taxation categories). The basis for this classification is the Combined Nomenclature (CN) used for customs purposes. The CN codes have 8-digits with the first 4-digits defining the product “heading” and being most relevant for the determination of the excise duty. The CN codes subject to excise taxation are:¹²⁷

CN / HS headings (4 digits)	8-digit
2203 Beer made from malt	3 subheadings
2204 Wine of fresh grapes, including fortified wines; grape must other than that of heading 2009	126 subheadings
2205 Vermouth and other wine of fresh grapes flavored with plants or aromatic substances	4 subheadings

¹²⁶ Ibid., p. 23.

¹²⁷ Study on Council Directive 92/83/EEC on the structures of excise duty on alcohol and alcoholic beverages, Final report, p. 30.

2206 Other fermented beverages (for example cider, perry, mead); mixtures of fermented beverages and mixtures of fermented beverages and non-alcoholic beverages, not elsewhere specified or included	7 subheadings
2207 Undenatured ethyl alcohol of an alcoholic strength by volume of 80% vol or higher; ethyl alcohol and other spirits, denatured, of any strength	2 subheadings
2208 Undenatured ethyl alcohol of an alcoholic strength by volume of less than 80% vol; spirits, liqueurs and other spirituous beverages	54 subheadings

Unlike the CN classification, the five excise categories for alcoholic beverages are also defined with reference to a second criterion. Namely, the minimum and maximum alcohol strength beyond which a product may change its category, regardless of its nature. For instance, any fermented or mixed beverage, including wine, beer and cider, above 22% vol will be taxed as "ethyl alcohol."¹²⁸

2. Reduced EU rates for low-strength alcohol – impact on health and innovation

The main approach currently used by the EU excise legislation for promoting innovation by taking into account health considerations is through the possibility for application of reduced excise rates falling below the set minimum levels for the respective tax category.

On the one hand, the EU legislation provides for minimum rates for some of the categories of alcoholic beverages. The Alcohol Rates Directive establishes positive minimum excise duty for beer, intermediate products, and ethyl alcohol. Conversely, there is no positive minimum excise duty for wine and OFB (the minimum rate being "zero"). Thus, wine and OFB are fully exempt from excise duty in several EU states (including Bulgaria) irrespective of their alcohol content.

On the other hand, the Alcohol Structures Directive allows Member States to apply reduced rates (below the minimum) on low-strength alcoholic beverages.

Although not explicitly stated in the EU directives, it is assumed that the lower rates are among the ways for tackling the negative effects of excessive alcohol consumption in line with public health considerations and encourage production of innovative goods with lower ABV.¹²⁹ In its study on Council Directive 92/83/EEC, the European Commission has outlined several specifics regarding the reduced rates relevant across all five tax categories.¹³⁰

First, for each category the Alcohol Rates Directive defines specific threshold in terms of actual alcoholic strength by volume under which the products are deemed of low strength, hence, Member States may apply reduced rates for products below the set threshold.

¹²⁸ Study on Council Directive 92/83/EEC, European Commission, Final Report, p. 33.

¹²⁹ In our view, it may be argued that somewhat similar effect is achieved by means of the reduced excise rates for small wine and beer producers; as we consider that these reductions are predominantly oriented toward specific segment of the alcohol producing sector and have less significant impact in terms of public health, we do not comment further on the incentives for small enterprises.

¹³⁰ Study on Council Directive 92/83/EEC on the structures of excise duty on alcohol and alcoholic beverages, European Commission, Final Report, June 2018, p. 132.

The thresholds for low-strength products are shown by also drawing parallel with the set minimum tax rate:

Product	Low-strength threshold	Minimum rate
<i>Beer</i>	2.8% vol (now increased to 3.5% vol)	EUR 0.748 per hectolitre/degree Plato or EUR 1.87 per hectolitre/degree alcohol of finished product
<i>Wine</i>	8.5% vol	EUR 0
<i>OFB</i>	8.5% vol	EUR 0
<i>Intermediate products</i>	15% vol	EUR 45 per hectolitre finished product
<i>Ethyl alcohol</i>	10% vol	EUR 550 per hectolitre pure alcohol at 20 degrees C

Second, in all product categories, beverages with an alcohol content not exceeding 1.2% vol are considered as "alcohol-free" by the Directive, therefore, not subject to excise duty. The only exception is beer, where the directive sets a lower threshold (0.5% vol) to apply the definition of "alcohol-free" product.

Third, depending on the category, excise duties and reduced rates are either applied as: (i) per hectolitre of product (wine, OFB and intermediate products) or (ii) per hectolitre / ABV (ethyl alcohol and beer in some MS) or per hectolitre / Plato degree (beer in some EU states).

The above implies one important difference in the EU excise taxation of the tax categories, namely, that:

- excise duty on beer and ethyl alcohol is rather proportional to their actual alcoholic strength
- excise duty on wine, OFB, and intermediate products is proportional to their overall volume (in liters) of product, irrespective of their alcoholic strength.¹³¹

Consequently, the specific taxation (deemed by the WHO as more favorable to public health policies and innovative production of low-alcoholic beverages) in the EU is rather applied in terms of beer and ethyl alcohol with the other three excise categories taxed on volume basis.

3. Areas for improvement of the policy for reduced rates

Even though the minimum rates differ per type of excise product, the study of the EU Commission on the Alcohol Structures Directive points out the necessity for further differentiation of the rates for low-strength alcohol.

This is because currently the rates are not always considering the products' specifics and their typical strength. For example, the definitions for low-strength wine below 8.5% is not in line with the one of the International Organization of Vine and Wine stating that the actual alcoholic strength by volume of wine should not be below 8.5% vol. This extends the scope of the excise

¹³¹ Ibid, p. 132.

provision to a “niche” market of very few drinks (such as sangria, glühwein and aromatized wine products).¹³² Similarly, in terms of ethyl alcohol, the minimum strength of 10% is running contrary to the EU spirit drink Regulation No 110/2008 whereby any spirit must have a minimum actual alcoholic strength of 15% vol.¹³³ These issues signal the need for changes in the reduced rates for certain categories (such as wine, intermediate products and ethyl alcohol) in order to achieve greater public health impacts from consumption of low-alcohol beverages.¹³⁴

Second, the actual minimum rate for wine is EUR 0 which practically leads to exemption in many EU states (including Bulgaria) making any incentive toward production of low-strength wine obsolete.

Third, currently the net impact of low-alcoholic products on public health is subject to somewhat differentiating views. The study of the European Commission on Council Directive 92/83/EEC indicates the poor systematic evidence on the public health policies generated by the existing reduced rates.

On the one hand, the study points toward the possibility that alcohol consumers switch to drinking low-strength alcohol without significantly increasing their overall consumption (in liters) of alcoholic beverages. In this case, reduced rates could lead to a less harmful use of alcohol, as defined by the WHO. On the other hand, the consumers may increase their consumption of low-strength products to “compensate” for the lower ABV content which may also be incentive for abstainers or adolescents to increase their consumption.¹³⁵

For this reason, the study concludes that the reduced rates are not successful when applied in isolation but should be coupled with other measures such as information and education campaigns, limitations on advertising and selling options etc.

Similar assessment is made in the 2016 evaluation report of Council Directive 92/83/EEC made by the EU Commission. In the said document, the Commission notes that the reduced rates are intended to encourage the production and consumption of lower-strength beverages within each category. The directive, however, does not explicitly state that these provisions are to be viewed as a tool for pursuing public health policy objectives which may negatively affect their implementation by Member States. The report further states that the general objective of the Alcohol Structures Directive is rather an “economic” one, i.e., to strike a balance between the harmonization of excise legislation in order ensure a functioning internal market and maintain the flexibility of individual Member States to set excise duties at a level corresponding to their needs.¹³⁶

4. Increase of the threshold for low-strength beer

The study of the Commission on Council Directive 92/83/EEC concludes, *inter alia*, with a proposition in favor of increased minimum threshold for low-strength beer (from 2.8% to 3.5%).

¹³² Ibid, p. 135.

¹³³ Ibid, p. 142.

¹³⁴ Ibid, p. 250.

¹³⁵ Ibid, p. 145.

¹³⁶ Evaluation of Council Directive 92/83/EEC on the harmonization of the structures of excise duties on alcohol and alcoholic beverages, Final report, European Commission, p. 24.

It is important to note that this proposal was adopted with Directive 2020/1151 of 29 July 2020 amending the Alcohol Structures Directive. In this sense, among the introduced changes is the possibility for application of reduced rates, below the minimum rate, for beer of actual alcoholic strength by volume not exceeding 3.5.% vol.

The recitals to the directive indicate the motive behind this change, namely, that the existing alcoholic strength to which reduced rates for low-strength beer may be applied is too low to provide any tangible incentive for brewers to be innovative and create new low-strength products. Consequently, in order to encourage the development of low-strength beer, the low-strength threshold is increased. Therefore, the directive outlines innovation toward low-strength (and probably less harmful) alcohol as the main reason for this change.¹³⁷

III. UK initiative for new alcohol duty system based on ABV content

This section is focused on the 2021 UK proposal for introduction of new alcohol duty system. Although still not adopted as of the date the current analysis (October 2022), the logic behind the proposal represents an interesting example of tax differentiation primarily based on public health objectives and in favor of unified taxation approach using the ABV as a main criterion (a position advocated by the WHO). The project argues that the existing UK system rests on historical product preferences that currently lead to anomalies and disparities and fails to align with public health objectives.¹³⁸

To address the issue, the UK government indicates that alcohol by volume (ABV) content should be the principal factor by which any alcoholic product is taxed. Thus, while there are qualitative differences between products, particularly between distilled and fermented beverages, ultimately it is their alcohol content which is a cause of social harm and public health concern. Consequently, the UK authorities are arguing in favor of the uniform application of the "specific" method for all types of alcoholic beverages, i.e., based on liters of pure alcohol contained.¹³⁹

Based on the above, products of the same ABV, as far as practicable, should pay the same rate of duty, regardless of their origin. Other qualitative differences, such as whether a product is still or sparkling, should not affect a product's duty rate. Consequently, the main shift is toward a progressive structure of alcohol duty in which lower ABV products pay proportionately less duty.¹⁴⁰ The proposed system is comprised of standardized series of bands for the rates, with rates for products between 1.2 - 3.4% ABV, 3.5 - 8.4% ABV, 8.5 - 22% ABV and above 22% ABV. For categories 8.5 - 22% ABV and above 22% ABV all products included will pay the same rate of duty as follows:¹⁴¹

¹³⁷ Directive (EU) 2020/1151 of 29 July 2020 amending Directive 92/83/EEC on the harmonization of the structures of excise duties on alcohol and alcoholic beverages.

¹³⁸ "The new alcohol duty system: Consultation", HMRC, October 2021, p. 20 - 22.

¹³⁹ Ibid.

¹⁴⁰ Ibid, p. 22 - 23.

¹⁴¹ Ibid, p. 31.

ABV	Beer	Cider	Wine, Made - wine and Spirits
0-1.2%		Nil	
1.3-3.4%		£ 8.42	
3.5.-8.45	£ 19.08	£ 8.78	£ 22.50
8.5-22%		£ 25.88	
22% +		£ 28.74	

Among the outlined benefits of the proposed new system by the UK government are:

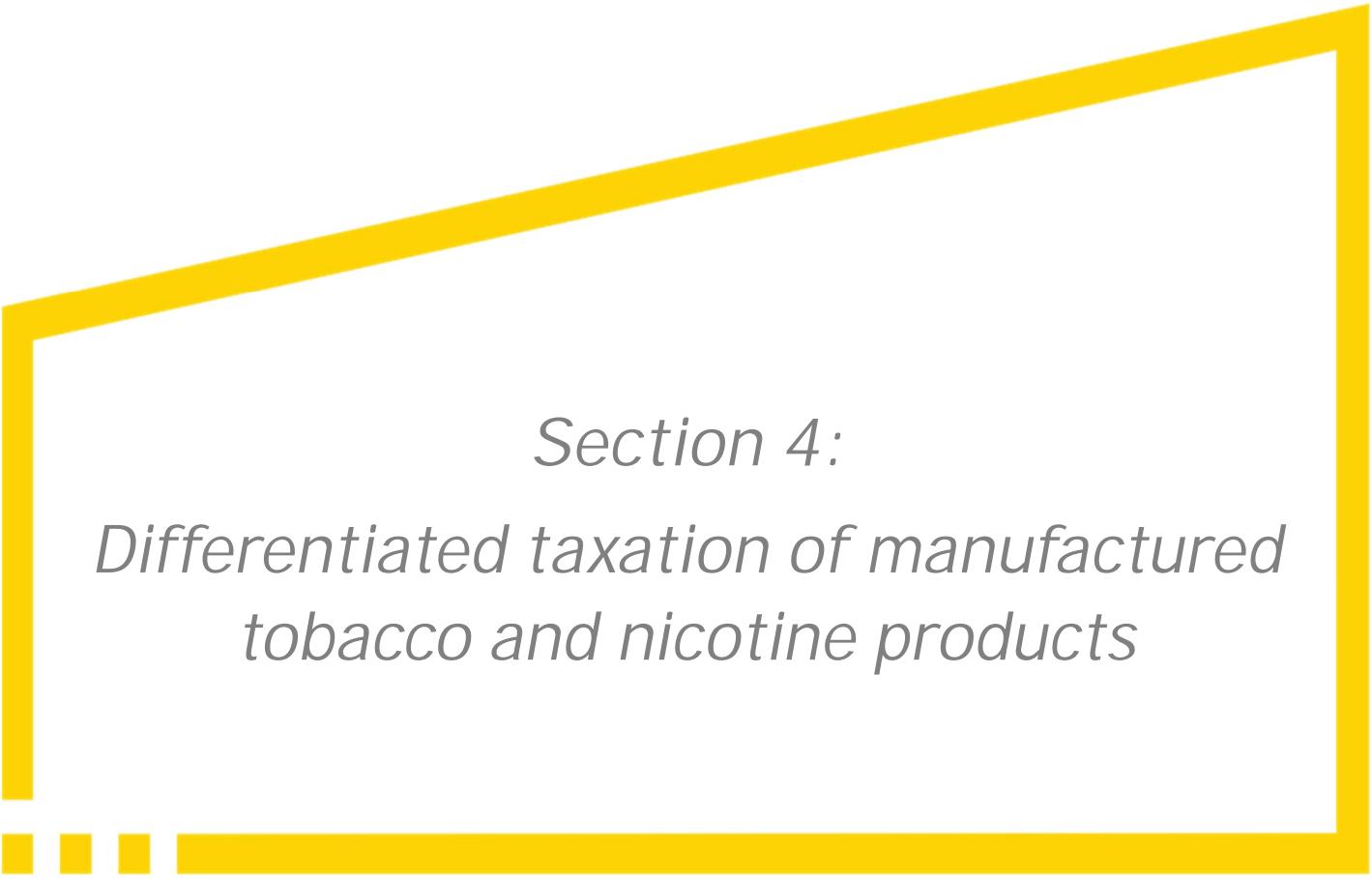
- Simpler taxation with a reduced number of bands based on a common method of taxation across all products and categories
- Fairer and more consistent approach, by using a common design framework for all the duties, and eliminating or narrowing the gaps between the categories where these are not justified on objective criteria
- Spurring innovation, by providing producers with a coherent basis of taxation, and removing anomalies that discourage new product development
- Supporting public health, by focusing on products that cause the highest harm, while in parallel relieving tax burden on products less associated with harm.

Alcohol consumption poses various economic, social and health considerations.

Excise taxes are widely regarded as the most efficient type of tax to achieve specific pricing policies toward alcoholic beverages. Excise taxation may be based on three main approaches: (i) specific as per ABV content, (ii) unitary based on volume and (iii) ad valorem based on sales price. The most suitable approach, to large extent, is conditional upon the goals targeted.

The WHO thus considers that the specific method is the most favorable one to support health policies and encourage innovation of alcohol producers toward low-strength drinks. The differentiation based on alcohol content is also a foundation of the proposal for a new alcohol policy in the UK.

Within the EU the major distinction for tax purposes between alcoholic beverages continues to be based on the historical distinction between several main tax categories of products: beer, wine, other fermented beverages, intermediate products and ethyl alcohol. This differentiation considers the existence of separate economic producing sectors related to each tax category. The main EU approach tackling with health issues is, therefore, the introduction of lower excise rates for low-strength beverages (e.g., low-strength beer).



Section 4:
Differentiated taxation of manufactured
tobacco and nicotine products

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Differentiated taxation of manufactured tobacco and nicotine products

In this section we analyze the main taxation principles currently applied to tobacco products as well as the ongoing developments for revision of Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco (“the Tobacco Excise Directive”). On the one hand, we focus on combustible tobacco products for smoking which have been for decades subject to harmonized excise legislation within the EU (cigarettes, cigars, cigarillos and smoking tobacco). In addition, we comment on recent trends regarding novel non-combustible tobacco and nicotine alternatives (NCAs) which are still not subject to EU harmonized taxation rules (e-cigarettes, heated tobacco products, smokeless tobacco products for oral use, nicotine pouches).

Our analysis does not aim to draw conclusions regarding the health implications from the combustible products or the reduced risk of NCAs use. However, we take into account the ongoing health debates to the extent that the products’ method of usage, non-combustion (smokeless) vs. combustion (smoking), impacts the criteria used for taxation. We also comment on Bulgarian trends regarding excise taxation of NCAs. Finally, we point out several aspects that may be taken into account for the future excise taxation of the NCAs in light of the expected revision of the Tobacco Directive.

I. Tobacco products – health and tax implications

1. Tobacco smoking - social aspects

Tobacco smoking has a history dating back to 6,000 BC.¹⁴² In Europe, the smoking habit was introduced by crewmen who sailed to the Americas as part of Columbus's voyage and subsequently brought tobacco from Cuba to Spain.¹⁴³ The spread of tobacco smoking across the world continued to be made by Spanish and Portuguese sailors.¹⁴⁴

In the 19th century in Europe, cigarettes were increasingly seen as a luxury item intended for usage mostly by the elites of the continent.¹⁴⁵ Tobacco, mainly cigarettes smoking, gained massive popularity during the First and Second World Wars, where cigarettes were widely used

¹⁴² "History of Tobacco" - <https://tobaccofreelife.org/tobacco/tobacco-history/> accessed on 15 September 2022.

¹⁴³ Ibid.

¹⁴⁴ "Tobacco: Its historical, cultural, oral, and periodontal health association" -

<https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3894096/> accessed on 15 September 2022.

¹⁴⁵ "A social and cultural history of smoking" - <https://www.britannica.com/topic/smoking-tobacco/A-social-and-cultural-history-of-smoking> accessed on 16 September 2022.

by soldiers on the frontlines.¹⁴⁶ In this regard the first half of the 20th century evidenced the boom of cigarettes consumption.¹⁴⁷ This spread was also caused by development of various tobacco products and the ability of the tobacco industry to market its products.¹⁴⁸

However, beginning from the 1950s and 1960s, various medical researchers started to publish evidence for a direct connection between smoking and various health hazards. These developments urged policymakers in different countries (including the USA and the UK) to undertake policies preventing further increase in smoking habits prevalence and tobacco consumption.¹⁴⁹

The beginning of the 21st century is marked with a decrease in the levels of smoking still not achieving the targets set by the WHO. Among the restrictive policies are imposed bans and limitations on advertising of cigarettes as well as measures limiting the opportunities for discounts / promotions on behalf of tobacco producers.¹⁵⁰ The growing health concerns have contributed to the development of new types of tobacco products that apply other forms of usage, i.e., without combustion and entailing lower health risks than smoking.¹⁵¹

2. Tobacco smoking – health aspects

- Health risks

According to different statistical studies, smoking dependence affects approximately 1.2 billion people across the world which, in turn, impacts various areas of social life, including by burdening the health systems and increasing the overall health costs. Smoking is perceived as the most significant cause of preventable premature mortality worldwide, mainly from lung cancer, coronary heart disease, chronic obstructive pulmonary disease, and stroke.¹⁵²

The main components of cigarettes, which are the most widely used tobacco product, are tobacco and other chemical additives to the tobacco mix as humectants or flavors, as well as filter and paper wrapper.¹⁵³ According to the WHO, smokers are exposed to a toxic mixture of over 7,000 chemicals, including tar, when they inhale cigarette smoke itself, and around 100 of them are carcinogenic. The mix of harmful chemicals in smoke can cause damage to almost every organ in the human body and cause chronic diseases, such as cardiovascular diseases, pulmonary diseases, metabolic conditions, cancers.

¹⁴⁶ "History of Tobacco"

¹⁴⁷ "A social and cultural history of smoking"

¹⁴⁸ "A brief history of smoking" - <https://www.cancercouncil.com.au/news/a-brief-history-of-smoking/> accessed on 16 September 2022.

¹⁴⁹ "A social and cultural history of smoking"

¹⁵⁰ "Epidemiology of Tobacco Use: History and Current Trends" National Academies of Sciences, Engineering, and Medicine. 2007. "Ending the Tobacco Problem: A Blueprint for the Nation." Washington, DC: The National Academies Press. - <https://nap.nationalacademies.org/read/11795/chapter/4#47> accessed on 16 September 2022.

¹⁵¹ Ibid.

¹⁵² "Polosa et al.: A fresh look at tobacco harm reduction: the case for the electronic cigarette." Harm Reduction Journal 2013 10:19.

¹⁵³ What Is In A Cigarette? Chemicals and Ingredient List Confirm How Dangerous Smoking Really Is, <https://www.medicaldaily.com/what-cigarette-chemicals-and-ingredient-list-confirm-how-dangerous-smoking-really-279718> accessed on 16 September 2022.

In addition to risks for smokers, smoking has a detrimental impact on bystanders ("passive smokers"). Through passive exposure to exhaled and emitted side stream smoke, which contains harmful chemicals, non-smokers close to the smoker are also exposed to health risks. Studies over time have also supported the view that smoking during pregnancy may be harmful to the fetal growth and development.

As smoking is closely linked to social status, the burden of ill health falls disproportionately on disadvantaged members of societies, making it among the major causes for social inequalities worldwide. In this regard, an overall negative consequence is increase in hospital and primary care costs coupled with reduced economic productivity and social engagement leading to deterioration in the quality of life.

The smoking prevalence has prompted various approaches aiming to curb its harmful effects.

- Approaches for reducing harmful effects of tobacco smoking

The initiative of the WHO to reduce the consumption of tobacco worldwide is outlined in the Framework Convention on Tobacco Control (FCTC). The FCTC was adopted in 2003 and is the first international treaty on public health in response to the globalization of tobacco consumption.¹⁵⁴ According to the FCTC, countries should implement tax and pricing policies on tobacco products that contribute to achieving health objectives aimed at tobacco use reduction.¹⁵⁵

Part of the health approaches are advocating in favor of total non-smoking interventions; others are related to encouraging nicotine replacement therapies while a third category favors replacing traditional combusted tobacco products for smoking with alternative ones that do not involve combustion and generation of smoke. In this relation, price and tax measures are viewed as means for reducing tobacco consumption within different segments of population, especially young people. Thus, while most health studies accept that outright smoking cessation is the best possible solution, there is a growing body of work focused on efforts advocating the shift to presumably less harmful products.

The said views acknowledge that complete smoking cessation, although desirable from health perspective, is a difficult task. Since nicotine is not the primary cause of smoking related diseases, it is therefore suggested that the provision of effective and affordable non-combustible alternatives may generate health benefits by allowing smokers to reduce harm by eliminating "tobacco smoke" without fully ceasing nicotine usage.¹⁵⁶

- Substitution based on risk profile (ongoing health discussions)

An area of scientific research that has developed during the last decade refers to analysis and comparisons of the substances contained in the emissions of different forms of tobacco use,

¹⁵⁴ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 25.

¹⁵⁵ "Electronic nicotine delivery systems" Report by WHO, September 2014.

¹⁵⁶ "Polosa et al.: A fresh look at tobacco harm reduction: the case for the electronic cigarette." Harm Reduction, Journal 2013; 1.

which may constitute a basis for risk stratification from health perspective, i.e., an approach based on risk profile.

Certain studies suggest that nicotine inhalation alone is unlikely to contribute to the mortality and morbidity caused by tobacco use, including by smoking.¹⁵⁷ A recent paper evaluating the legislative framework for tobacco control issued by the European Tobacco Harm Reduction Advocates (ETHRA), a consortium of 25 grassroots EU consumer associations supported by health experts, presents their data and views in this regard.¹⁵⁸

According to the research conducted by ETHRA, it is smoke inhalation, not nicotine, which is the primary cause of health issues. Hence, the EU health policies should focus on reducing smoking as being the most massive and widely used form of tobacco consumption. Smoking accounts for 98% of the global burden of tobacco-related mortality with the primary cause of harm being not the nicotine but the inhalation of constituents released from the combustion process in the smoke, i.e., the toxic chemicals, including the mixture of carbon-based particulate matter, often called "tar" and other chemical substances created during the burning of tobacco in a cigarette.

The study further quotes the British scholar prof. Michael Russel who argued that the risk of lung cancer and bronchitis may be reduced if the focus is shifted from the nicotine to the tar intake. The tobacco harm reduction strategy should be aimed at reducing the exposure to toxic substances, including to tar, from the cigarette smoke.¹⁵⁹

The health policies, therefore, may have as their goal the harm reduction by means of substitution of the most harmful tobacco products with less harmful non-flammable alternatives.¹⁶⁰

Most of the opinions supporting the idea of using the NCAs as a less harmful option refer to scientific studies according to which the main reason for the fatal harmful effects is the smoke produced by the combustion process.¹⁶¹ Among the cited examples is a report by the UK Royal College of Physicians stating that if nicotine could be delivered effectively to smokers without smoke, most of the harms from smoking could be avoided.¹⁶² Similar conclusion is reached by Public Health England, an executive agency of the Department of Health and Social Care in England, according to which vaping poses only a small fraction of the risk from smoking while the switch from smoking to vaping conveys substantial health benefits over continued smoking.¹⁶³

Irrespective of the above, according to the EU Commission, there is still an ongoing debate across the EU and globally regarding the ultimate health impact of novel products (mostly e-cigarettes and HTPs) in the long run. The reason for this is the substantial disparity of views

¹⁵⁷ "WHO raises alarm on tobacco industry environmental impact"., <https://www.who.int/news-room/detail/31-05-2022-who-raises-alarm-on-tobacco-industry-environmental-impact> accessed on 16 September 2022.

¹⁵⁸ "Evaluation of the legislative framework for tobacco control - call for evidence", European Tobacco Harm Reduction Advocates (ETHRA).

¹⁵⁹ Ibid., p. 6.

¹⁶⁰ "Nicotine without smoke Tobacco harm reduction." Tobacco Advisory Group of the Royal College of Physicians. London: RCP, 2016.

¹⁶¹ "Nicotine without smoke Tobacco harm reduction."

¹⁶² Ibid.

¹⁶³ "Evidence review of e-cigarettes and heated tobacco products 2018," Public Health England.

among public health experts about the inherent risk and smoking cessation potential of the NCAs.

An example cited by the Commission for this polarization are, on the one hand, the mentioned UK Royal College of Physicians and Public Health England papers and, on the other hand, a report from 2016 by the US Department of Health and Human Services. The latter has concluded that e-cigarette's aerosol is not harmless, and that e-cigarettes use among youth and young adults may itself pose a public health concern.¹⁶⁴

3. Interaction between health and economic goals in the EU excise taxation

The health aspect is inseparable from the excise taxation of tobacco products. In this relation, from its onset, the EU Tobacco Excise Directive is explicitly aimed at achieving a dual goal ensuring:

- (i) the functioning of the internal market (economic goal) and
- (ii) human health protection (public health goal).

Thus, unlike with other excise products subject to harmonized EU excise taxation (e.g., energy products and alcohol) this explicit dual role is placing the two objectives as primary ones at the same level, while, needless to say, national objectives are to secure strong excise budget revenues.¹⁶⁵

Having said this, the EU Commission itself acknowledges that the historical focus of the Tobacco Excise Directive has been on achieving the proper functioning of the single market.¹⁶⁶ Furthermore, the two EU goals may be even regarded as internally contradicting. This is because, on the one hand, taxation policies aim to extend the freedoms of the single market to the manufactured tobacco sector by means of harmonized excise structures and minimum taxation levels. On the other hand, the excise directive is supposed also to contribute to the discouragement of tobacco consumption for public health reasons by measures such as decreased affordability of cigarettes and tobacco (e.g., by increasing prices of tobacco products, prohibition or restriction of sales of tax-free and duty-free items).¹⁶⁷ For this reason, the EU Commission has assessed that the "health" statement is more a declaration of principle and it is not supported by any quantification of targets or reference to external policies articulating this objective.¹⁶⁸

Furthermore, the proper functioning of the internal market includes the basic freedom for the manufacturer of setting the retail selling price. The Tobacco Excise Directive thus declares that the imperative needs of fair competition imply a system of freely formed prices for all

¹⁶⁴ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 140 - 141.

¹⁶⁵ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 7.

¹⁶⁶ *Ibid.*, p. 46.

¹⁶⁷ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Executive Summary, p. 5.

¹⁶⁸ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 146.

manufactured tobacco products. Consequently, any direct/indirect mandatory price system imposed on manufacturers or importers for public health reasons would be incompatible with the Tobacco Excise Directive.¹⁶⁹ For this reason, one of the aims of future legislation should be to bring closer the two main objectives (economic and health) and strike a balance between the two.¹⁷⁰

4. Categories of tobacco and nicotine products

Before we go to the main tax policies related to tobacco and nicotine products, it is first necessary to provide an overview of the basic types of products subject to taxation. For the purposes of our analysis, we differentiate the products into two main categories based on their current tax treatment and method of functioning: (i) traditional combustible products already subject to harmonized EU taxation in the excise area and (ii) novel NCAs still not subject to harmonized EU excise treatment.

(A) Combustible tobacco products

The scope of the Tobacco Excise Directive covers the following three main types of products:

- (i) cigarettes
- (ii) cigars and cigarillos
- (ii) smoking tobacco subdivided into:
 - a. fine-cut tobacco (FCT) for the rolling of cigarettes
 - b. other smoking tobacco (OST).

In terms of the characteristics of usage, Art. 3 to Art. 5 of the Tobacco Excise Directive lists definitions to the different products by referring to them as "capable of being smoked." In this regard, although not explicitly stated in the Tobacco Excise Directive, it may be argued that the scope of the current excise rules extends to products characterized by smoking itself linked to a tobacco combustion process. This process, on the other hand, is absent in the new NCAs which may constitute a clear separation criterion for future tax differentiation between the two categories.

It is also notable that, unlike other excise products such as alcohol and energy products, the Tobacco Excise Directive does not contain explicit references to the Combined Nomenclature (CN) codes used for customs purposes.

From customs perspective, the CN currently includes the following tobacco codes under Chapter 24 "Tobacco and Manufactured tobacco substitutes":¹⁷¹

¹⁶⁹ Ibid., p. 146 – 147.

¹⁷⁰ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 56.

¹⁷¹ Chapter 24 Tobacco and manufactured tobacco substitutes; products, whether or not containing nicotine, intended for inhalation without combustion; other nicotine containing products intended for the intake of nicotine into the

CN / HS headings (4 digits)
2401 Unmanufactured tobacco; tobacco refuse
2402 Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
2403 Other manufactured tobacco and manufactured tobacco substitutes; 'homogenised' or 'reconstituted' tobacco; tobacco extracts and essences
2404 Products containing tobacco, reconstituted tobacco, nicotine, or tobacco or nicotine substitutes, intended for inhalation without combustion; other nicotine containing products intended for the intake of nicotine into the human body

Notably, the 2022 version of the CN introduces for the first time a new separate 4-digit heading 2404 for products intended for inhalation and used without combustion, i.e., prior versions of the CN included only headings 2401, 2402 and 2403 which rather relate to combustible products. The notes to the CN regarding heading 2404 clarify that the expression "inhalation without combustion" means inhalation through heat delivery or other means, without combustion. In other words, the lack of combustion process is considered a defining characteristic of the novel products for their customs classification. A conclusion could be drawn that the approved CN has appropriately included the new NCAs in its scope providing a solid base for revision of the Tobacco Excise Directive to leverage on the CN similarly to the approach to energy products and alcoholic beverages.

(B) Non-combustible alternatives (NCA)

The NCA are novel products that have become increasingly popular during the last decade but are still not subject to harmonized taxation at EU level and include:

- (i) Electronic cigarettes (e-cigarettes)
- (ii) Heated tobacco products (HTPs)
- (iii) Smokeless tobacco products (STPs) such as chewing, nasal, oral tobacco¹⁷²
- (iv) Nicotine pouches.

Below we comment in more detail each segment.

- E-cigarettes

E-cigarettes are categorized by the study group of the WHO as "electronic nicotine delivery systems in which tobacco is not required for their operation."¹⁷³ These products essentially

human body - <http://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs-nomenclature-2022-edition/hs-nomenclature-2022-edition.aspx> accessed on 18 September 2022.

¹⁷² "Measuring the public-health and economic effects when changing consumer habits by switching from traditional tobacco products for smoking to new non-combustible nicotine alternatives", Stoyan Panchev and Arkadi Sharkov, p. 2.

¹⁷³ "Polosa et al.: A fresh look at tobacco harm reduction: the case for the electronic cigarette."

consist of a cartridge filled with e-liquid, a battery, a heater and a mouthpiece, with newer generation devices allowing modifications and replacement of individual components according to user's preference. They could be disposable and re-useable.

No tobacco as a substance is present in these products. The e-cigarettes are smokeless non-combustible products, in which instead of tobacco that contains naturally nicotine, they heat a solution with or without nicotine, including also propylene glycol, glycerin and various flavorings which are classified by the US Food and Drug Administration (FDA) as "Generally Recognized as Safe."¹⁷⁴

The aerosol produced by heating the liquids and inhaled by the user is essentially a vapor, hence the widespread terminology of "vaping" to denote e-cigarettes consumption.¹⁷⁵

Although, the Tobacco Excise Directive does not include reference to e-cigarettes, a definition is provided for in Art. 2 of Directive 2014/40/EU on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products. The said definition states that e-cigarettes are ones that can be used for consumption of nicotine-containing vapor via a mouthpiece, or any component of that product, including a cartridge, a tank and the device without cartridge or tank. E-cigarettes can be disposable or refillable by means of a refill container and a tank, or rechargeable with single use cartridges.

For taxation purposes, it is the liquids that represent the excise taxable element of the electronic cigarettes. Vaping does not involve the formation of smoke produced from combustion process. For this reason, certain studies indicate that while e-cigarette vapor contains a number of potentially toxic compounds, these are at lower levels compared to cigarette smoke.¹⁷⁶ Furthermore, according to scientific research performed by the UK Royal College of Physicians the vapor is less harmful than the tobacco smoke since:

*"It is known... that the vapor does not deliver appreciable amounts of carbon monoxide, which represents a significant advantage relative to tobacco smoke. A study of carcinogen excretion in participants' urine after use of e-cigarettes or tobacco cigarettes found significantly lower levels of TSNAs, benzene and polycyclic aromatic hydrocarbons with e-cigarettes, demonstrating systemic absorption of these carcinogens and hence some degree of potential cancer risk, although clearly much less than that associated with smoking."*¹⁷⁷

Currently the Bulgarian Excise Duties and Tax Warehouses Act (EDTWA) includes a definition for e-cigarettes which are subject to excise taxation as of March 2023. The definition provides that "electronic cigarette liquid containing nicotine" is a liquid that is used by inhaling a vapor

¹⁷⁴ "An updated overview of e-cigarette impact on human health". Department of Pharmacology, Faculty of Medicine, University of Valencia, Avda. Blasco Ibañez 15, 46010 Valencia, Spain. Institute of Health Research INCLIVA, University Clinic Hospital of Valencia, Valencia, Spain. CIBERDEM-Spanish Biomedical Research Centre in Diabetes and Associated Metabolic Disorders, ISCIII, Av. Monforte de Lemos 3-5, 28029 Madrid, Spain, May 2021; 7-8.

¹⁷⁵ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 107 - 108.

¹⁷⁶ "Polosa et al.: A fresh look at tobacco harm reduction: the case for the electronic cigarette."

¹⁷⁷ Tobacco Advisory Group of the Royal College of Physicians. Nicotine without smoke Tobacco harm reduction. London: RCP, 2016: 81-82.

obtained as a result of heating without combustion and is intended for use with electronic cigarettes or is contained in refillable containers within the meaning of § 1, items 39 and 40 of the additional provisions of the Act on Tobacco, Tobacco Products and Related Products (TTPRP). It should be noted that the novel definition explicitly indicates the lack of combustion process.

Based on the definition, electronic cigarette liquid containing nicotine is to be considered a tobacco product. In turn, the liquid is to be used by inhaling a vapor produced as a result of heating without combustion and is intended for use with electronic cigarettes or is contained in refillable containers.

TTPRP, on the other hand, contains a definition for "electronic cigarette" as a device that can be used to consume nicotine-containing vapor through a mouthpiece, or a component of such a device, including a cartridge and tank, and the device without a cartridge or tank. E-cigarettes can be single-use or reusable via a refillable container and tank, or refillable via single-use cartridges.¹⁷⁸

- Heated tobacco products (HTPs)

HTPs are tobacco products used by heating devices which, in the recent years, have increasingly been gaining popularity in different EU countries including Bulgaria. These devices heat the tobacco under a specific temperature range by using an electronic heat control system (itself preventing the tobacco from burning). The use of tobacco is a major difference with electronic cigarettes (whereby the electronic cigarette uses a liquid).

HTPs are not harmonized in the Tobacco Excise Directive as of December 2022. The said directive is expected to be revised and to include the new tobacco and nicotine products. In this regard most of the EU Member States have opted to introduce HTPs as excisable manufactured tobacco product, with most of them having classified the products as smokeless, due to the lack of combustion, hence, not for smoking.

As of 2017, the Bulgarian EDTWA includes HTPs within the scope of "tobacco products." The legal definition is for "a type of smokeless tobacco product during the usage of which the tobacco contained therein does not burn but the usage is effected through heating of the product resulting in release of an aerosol."¹⁷⁹

In this regard, the local excise law explicitly indicates the lack of combustion (burning) process upon their usage. As noted by the Commission, although different in many respects, HTPs and e-cigarettes have in common the absence of self-sustained combustion processes and for this reason are often defined in Member States' legislation as "non-combustible."¹⁸⁰

In 2020 the FDA authorized specific electrically heated tobacco system by classifying it as a "modified risk tobacco product" (MRTP). The FDA also concluded that since such system heats tobacco and does not burn it, that same system significantly reduces the body exposure to

¹⁷⁸ § 1, point 39 from the Additional Provisions of the Act on Tobacco, Tobacco Products and Related Products.

¹⁷⁹ Art. 12a from the Excise Duties and Tax Warehouses Act.

¹⁸⁰ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 114 - 115.

harmful or potentially harmful chemicals thus potentially assisting addicted smokers to transition away from combusted cigarettes and reduce their exposure to harmful chemicals in case of complete switch (with the warning that the FDA will continue to monitor if the product meets this potential).¹⁸¹

Acknowledging that their ultimate effect on smoking and health is still an “open” scientific matter, the comparison between HTPs and cigarettes made in various scientific research nevertheless suggests that HTPs could potentially be a less harmful alternative for adult smokers who would otherwise continue to smoke cigarettes.¹⁸²

The argument is that HTPs produce a much simpler aerosol than cigarette smoke, with fewer and significantly lower levels of harmful toxic substances. This is thought to be a result of the fact that the harmful chemicals in the cigarette smoke are created through burning/combustion of tobacco. The assertion is that heating alone, rather than burning the tobacco, can reduce the amount of harmful chemicals that the user inhales. Although toxic compounds are not completely removed from the heated tobacco aerosol, these reductions end in reduced biological effects, including on passive smokers, as the aerosol from heating tobacco does not have negative effect on the air quality in closed premises.¹⁸³

In order to assist in the analysis of the health impact from HTPs, the WHO has undertaken to further examine the chemical and physical processes that these products undergo, including the characterization of their emissions. The goal is to define possible revisions of definitions/terminology and advise on the adequate regulatory classification.¹⁸⁴

- Smokeless tobacco products (STPs) for oral use

The distribution of STPs for oral use is currently negligible in Bulgaria.¹⁸⁵ Such products (notably for chewing or snuff), and particularly snus, which is currently banned in EU, are used in some of the Nordic countries.

Sweden is the only EU country where the sale of snus is legal and, at the same time, it is legal for foreign travelers to buy snus and carry it back for personal use. There are data and evidence that show that the usage of snus is coupled with low smoking prevalence figures in Sweden and lower morbidity and mortality rates from NCDs.¹⁸⁶ According to the EU Commission, although a

¹⁸¹ FDA News Release accessed at: <https://www.fda.gov/news-events/press-announcements/fda-authorizes-marketing-iqos-tobacco-heating-system-reduced-exposure-information> on 25 September 2022.

¹⁸² Connor R Miller, Edward Sutanto, Danielle M Smith, Sara C Hitchman, Shannon Gravely, Hua H Yong, Ron Borland, Richard J O'Connor, K Michael Cummings, Geoffrey T Fong, Andrew Hyland, Anne C K Quah, Maciej L Goniewicz: Awareness, trial and use of heated tobacco products among adult cigarette smokers and e-cigarette users: findings from the 2018 ITC Four Country Smoking and Vaping Survey, September 2020; 11, 13-14.

¹⁸³ Cochrane Database of Systematic Reviews published by John Wiley & Sons, Ltd. on behalf of The Cochrane Collaboration: Heated tobacco products for smoking cessation and reducing smoking prevalence (Review), 2022.

¹⁸⁴ “Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco”, Final Report - Volume 1, January 2019, p. 114.

¹⁸⁵ “Measuring the public-health and economic effects when changing consumer habits by switching from traditional tobacco products for smoking to new non-combustible nicotine alternatives”, Stoyan Panchev and Arkadi Sharkov, p. 2.

¹⁸⁶ “Evaluation of the legislative framework for tobacco control - call for evidence”, European Tobacco Harm Reduction Advocates (ETHRA), p. 4.

direct link between the decreasing use of cigarettes and the increasing use of snus is difficult to establish, the phenomenon should be nevertheless considered.¹⁸⁷

Interestingly enough, the Commission has also noted about a contradiction concerning tobacco for oral use between EU rules and accession agreements of certain states. In this regard Directives 89/622/EEC and 2001/37/EC prohibit the sale in the EU of specific tobacco for oral use. On the other hand, the act of accession of Austria, Finland and Sweden granted these countries a derogation from the said prohibition which has caused the Swedish government and producers to challenge the prohibition on several occasions. According to the Commission, however, the inclusion of these products in the common excise regime could have paradoxically led to legal disputes under the EU law concerning their free circulation within the EU.¹⁸⁸

The current analysis does not focus in detail on the STPs for oral use. This is because, on the one hand, they are of more limited popularity and usage in the EU and Bulgaria in comparison with e-cigarettes and HTPs and, on the other hand, because of the insufficient number of available scholarly analyses or suggested policies for inclusion of these products within the scope of the revised Tobacco Directive.

- Nicotine pouches - smokeless non-tobacco nicotine products for oral use

Nicotine pouches are gradually gaining popularity in the EU and Bulgaria which potentially demonstrates the consumer needs for less harmful alternatives for nicotine delivery. These products deliver nicotine via the mouth saliva, similarly to snus. However, they do not contain tobacco, but other solid base of nicotine salts, that are offered in dust or tiny particles packed in one doze pouches. The European Commission may take a decision to include this emerging product in the revision of the Tobacco Excise Directive.

II. Taxation of tobacco products

1. Types of taxes on tobacco

Taxes levied on tobacco products may be distinguished as consumption taxes and customs duties¹⁸⁹ both of which fall into the category of indirect taxes. Consumption taxes refer to "a tax system with a taxable base of consumption" and include VAT and excise duties.¹⁹⁰

VAT is a "universal" sales tax that is usually not dependent on the type of goods being taxed (unless a reduced rate or exemption applies). Excise duties are specifically focused on taxing a limited number of goods including tobacco products. Finally, customs duties are assessed upon importation of goods from non-EU countries and usually are specific or *ad valorem*.¹⁹¹

¹⁸⁷ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 35 - 36.

¹⁸⁸ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 124.

¹⁸⁹ "IARC Handbooks of Cancer Prevention, Chapter 2: Overview to tobacco taxation".

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

It may be said that increase of any of the above indirect taxes will impact prices of tobacco products. However, excise duties may be deemed as most suitable by directly targeting the pricing of all tobacco products distributed to any final consumer on the local market including in accordance with the health protection policies chosen by each EU country. On the other hand, VAT is a general tax on consumption applicable to all goods / services while customs duties are levied only on goods with non-Union status.

In the EU, excise duties on combustible products are harmonized with the common EU Tobacco Excise Directive. The policy instruments include:¹⁹²

- (i) definition of common tax categories subject to excise
- (ii) harmonization of excise structures including "mixed" one for cigarettes
- (iii) introduction of minimum excise rates.

As of the date of the current analysis, NCAs are not subject to harmonized EU excise taxation and their application is left to each Member State's discretion. Such taxation, therefore, remains an important outstanding matter from the perspective of the common EU market and an aligned health approach to novel products.

Excise taxation based on above elaborated difference between the two groups of products, in our view, may be based on differentiated taxation approach applied to traditional combustible products vis-à-vis NCAs.

2. Excise taxation of combustible products within the EU and Bulgaria

The EU has introduced harmonized rules on the excise duties to manufactured tobacco since the 1970s and some of the definitions provided at that time are still applicable.¹⁹³ The initial impetus for harmonization was the alignment between EU states which produce tobacco (usually applying price proportional taxes favoring their cheaper domestic production) with Member States that are consumers (favoring specific taxation per number of units).¹⁹⁴

The Tobacco Directive from 2011 codifies three earlier tobacco directives¹⁹⁵ and determines the structure and excise duty rates as well as defines the various manufactured tobacco products according to their characteristics.¹⁹⁶ In the EU, where tax burden on cigarettes exceeds 70%, taxation has a major effect on tobacco prices.¹⁹⁷ At the same time, the way Member States

¹⁹² "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Executive Summary, p. 5 - 6.

¹⁹³ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020.

¹⁹⁴ "Introduction to the European Excises (2008/118/EC)", Ben Terra, Julie Kajus and Hans Winkels, p. 101.

¹⁹⁵ Ibid, p. 108.

¹⁹⁶ "Report from the Commission to the Council on the REFIT evaluation of Directive 2011/64/EU and on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 21.12.2015, p. 3.

¹⁹⁷ Tobacco Tax Reform A Multisectoral Perspective, "At the Crossroads of Health and Development", p.110 - 111.

choose to tax combustible products should neither distort competition within the common market nor impact their free movement.¹⁹⁸

The harmonized EU legislation only sets common minimum rates but EU states are free to apply excise duty rates above these minima, according to their own national needs.

- Cigarettes

Unlike other tobacco products, the minimum rate for cigarettes consists of the following components:

- ▶ Specific - between 7.5% and 76.5% of the total tax burden expressed as a fixed amount per 1000 cigarettes
- ▶ Ad valorem - as a percentage of the retail selling price
- ▶ Total minimum (overall excise rate) which should be at least: (i) EUR 90 per 1000 cigarettes and (ii) 60% of the weighted average retail selling price.

Due to the EU accession of Bulgaria in 2007, the EDTWA has started to gradually introduce the EU requirements.¹⁹⁹ The post-accession excise policy in the country can be split up into three main periods.²⁰⁰ During the first stage (following accession until 2010) the trend is marked with a rapid increase of the excise on cigarettes aiming to reach the minimum EU levels. The increase, however, exceeded the minimum EU threshold for 2010 (EUR 64 per 1000 pieces) and reached EUR 76 per 1000 cigarettes thus leading to an undesired proliferation of the illegal market.²⁰¹ The second stage between 2010 and 2015 is characterized with a "freeze" in the rates. This trend was again reversed during the third stage (2016 - 2018) marked with somewhat versatile changes ultimately leading to an adoption of a gradual timeframe (calendar) for increase reaching the 2018 EU minimum level of EUR 90 per 1000 cigarettes.²⁰²

As of beginning of December 2022 excise rates in Bulgaria are:

- ▶ specific - BGN 109 per 1000 cigarettes
- ▶ *ad valorem* (proportional) - 25% of the selling price and
- ▶ total minimum excise rate - not less than BGN 177 per 1000 cigarettes²⁰³

The total minimum of BGN 177 per 1000 pieces is the EU minimum of EUR 90 and in practice places Bulgaria among the lowest taxing EU states including following the tax increases from 2018.

¹⁹⁸ Articles 26, Article 113 and Article 168 of the Treaty on the Functioning of the European Union (TFEU).

¹⁹⁹ The Excise Duties and Tax and Warehouses Act was promulgated in State Gazette No. 91/15.11.2005, effective 1.01.2006.

²⁰⁰ "Measuring the public-health and economic effects when changing consumer habits by switching from traditional tobacco products for smoking to new non-combustible nicotine alternatives", Stoyan Panchev and Arkadi Sharkov

²⁰¹ Ibid.

²⁰² Ibid.

²⁰³ See Article 39 of the EDTWA.

- Other products (fine-cut smoking tobacco, cigars, cigarillos and other)

In terms of taxing "other tobacco products" the Tobacco Excise Directive allows Member States to choose between applying a specific or an ad valorem component or even a mixture of the two. The EU minimum rates are:²⁰⁴

Product Category	Minimum Rate
<i>Fine-cut smoking tobacco</i>	48% of the weighted average retail selling price* Or EUR 60 per kilogram*
<i>Cigars and Cigarillos</i>	5% of the retail selling price Or EUR 12 per 1000 or per kilogram
<i>Other smoking tobaccos</i>	20% of the retail selling price Or EUR 22 per kilogram

* To gradually increase, by 2020, to 50% or EUR 60

The Bulgarian EDTWA provides for the following rates:

- ▶ Tobacco for smoking (for pipes and cigarettes) – BGN 152 per kilogram (unified specific rate per kilogram)²⁰⁵
- ▶ Cigars and cigarillos – BGN 270 per 1000 items (specific rate per number of pieces).²⁰⁶

In light of the above, the Bulgarian rate for smoking tobacco as of the beginning of December 2022 (approx. EUR 78 per kilogram) exceeds the EU minimum for fine-cut smoking tobacco (EUR 60 per kilogram) while the one for cigars and cigarillos (EUR 138 per 1000 pieces) is significantly above the EU minimum (EUR 12 per 1000 pieces).

3. Excise taxation of NCAs within the EU and Bulgaria

The taxation of the NCAs is subject to diversified approaches across the Member States.

- E-cigarettes

According to a report of the EU Commission from 2020, at the time of the report around half of the Member States have already introduced an ad-hoc tax at national level on e-cigarettes.²⁰⁷ This results in significant fragmentation impeding cross-border sales.²⁰⁸

²⁰⁴ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 72 – 73.

²⁰⁵ Article 38 of the EDTWA.

²⁰⁶ Article 37 of the EDTWA.

²⁰⁷ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 13.

²⁰⁸ Ibid., at p. 41.

The base subject to taxation is the consumable liquid (itself vaporized). The EU taxing countries predominantly apply a rate of several dozen euro cents per milliliter of liquid.²⁰⁹ This is in practice a specific tax per volume of product. However, about half of the countries apply it only to nicotine-containing liquids while the other half assess it to any liquid for consumption in an e-cigarette device.²¹⁰ These differing approaches reflect one specific difficulty in taxing e-liquids. Namely, not all the liquids used with electronic cigarettes contain nicotine and not all the nicotine is in the same concentration.²¹¹

The average price of e-liquids in the EU is approximately EUR 0,51 per milliliter, which is generally lower than in certain non-EU countries such as Norway and Australia but higher than in Switzerland and the US.²¹²

Beginning from March 2023 the Bulgarian EDTWA imposes excise duty on the liquids for e-cigarettes (see next section).

- Heated tobacco products (HTPs)

HTPs have already been introduced in twenty-two EU states as taxable products. Most of these countries are applying an ad-hoc tax regime on a non-harmonized category (implying that they treat HTPs as smokeless products or non-combustible products, hence, within a specific excise tax category different than smoking tobacco products). Few other states set the rates at the level of "other smoking tobacco" harmonized category²¹³ but primarily to ensure their movement under the Excise Movement and Control System (EMCS).²¹⁴

Majority of countries tax the HTPs by tobacco mixture weight, i.e., per kilogram. The weight tax base is the most appropriate and convenient tax base, since HTPs are novel tobacco products and they appear in various formats, shapes and type whereby the common denominator is tobacco content. Some exceptions include Italy and Hungary, which tax by unit (stick) and Portugal which has a mixed specific (based on tobacco mixture weight) and ad valorem (as a percentage of the retail selling price) regime.²¹⁵ The EU rates vary significantly.

The Bulgarian EDTWA has introduced excise duty for HTPs in 2017 by determining, like majority of the EU states, the tax base as the amount of tobacco contained in the product and measured in kilograms.²¹⁶ The initial tax rate was BGN 152 per kilogram (same as the tobacco for smoking) but was increased in 2018 to BGN 233 per kilogram.²¹⁷

²⁰⁹ Ibid., at p. 42.

²¹⁰ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 10.

²¹¹ Ibid., at 144.

²¹² "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Final Report - Volume 1, January 2019, p. 111.

²¹³ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 15.

²¹⁴ "Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Executive Summary, p. 10.

²¹⁵ Ibid.

²¹⁶ Art. 29(3) of the Excise Duties and Tax Warehouses Act.

²¹⁷ Art. 38(2) of the Excise Duties and Tax Warehouses Act.

Effective from March 2023, tobacco products in Bulgaria are subject to a new tax calendar which also covers changes in the duties for HTPs (see next section).

4. New Bulgarian excise calendar for increased tax rates of tobacco products

Changes to the excise rates of tobacco products have been adopted with the Law on Amendments and Supplements to the Tax and Social Security Procedures Code promulgated with issue No 100 of State Gazette from 16 December 2022. The amendments in the excise legislation concern the introduction of a calendar for a gradual increase in the rates for all categories of tobacco products into force as of March 2023 until January 2026.

The calendar introduces the following overall percentage increase (in comparison with the current level) in the rates between the individual categories of tobacco products:

- Cigarettes - (general) excise duty rate - not less than BGN 211 per 1,000 cigarettes from January 1, 2026; compared to the current rate of BGN 177 for 1000 pieces, this is a percentage increase of 19.20%
- Cigars and cigarillos - excise rate of BGN 396 per 1,000 pieces from January 1, 2026; compared to the current rate of BGN 270 for 1,000 pieces, the percentage increase is 46.66%
- Smoking tobacco - excise rate of BGN 222 per kilogram from January 1, 2026; compared to the current rate of BGN 152 per kilogram, the percentage increase is 46.05%
- Heated tobacco products - excise rate of BGN 400 per kilogram from January 1, 2026; compared to the current rate of BGN 233 per kilogram, the percentage increase is 71.67%
- Liquid for electronic cigarettes containing nicotine - excise rate of BGN 0.18 per milliliter from March 1, 2023 and reaching BGN 0.35 per milliliter from January 1, 2026 or a percentage increase after the introduction of excise duty in the amount of 94.44%.

The introduction of such a calendar is, in principle, a positive step toward achieving certainty of the tax and regulatory environment, including in terms of avoiding a sharp increase in the excise rates as well as undesired consequences for the businesses, state budget and consumers. In addition, as a part of the discussions on the changes to EDTWA, a debate was held in the National Assembly about the health aspect and the differing risk profiles of NCAs when compared to combustible products.

In addition, it is in line with the EU trend that growing number of countries are implementing multi-year excise tax plans for HTPs, e.g., thirteen EU Member States (including Bulgaria) have multi-year HTP tax calendars. For reference, Austria and Romania implemented new multi-year tax calendars in 2022 via recognizing the vital role of tobacco harm reduction (Austria) and/or reduced risk potential of HTP and e-cigarettes (Romania).²¹⁸ Furthermore, Italy recently renewed its previous multi-year tax plan on HTP (2021-2023) to 2026 with an opinion from its Court of Auditors' stating that excise tax differentiation for HTPs "*theoretically responds to the principle*

²¹⁸ Austria: [Budgetbegleitgesetz 2023 – BBG 2023 \(1776 d.B.\) | Parlament Österreich](#)
Romania: [Legea nr.227/2015 \(anaf.ro\)](#)

*that the level of excise duties should have a correspondence with the extent of the social damage caused by the consumption of these products.*²¹⁹ Despite the abovementioned positive developments, the currently adopted local policy concerning increased rates for different tobacco products remains questionable in the context of the European practice on this issue. This is due to the fact that the introduced rates lead to a taxation whereby the most widely used but harmful products (cigarettes) are subject to the lowest overall percentage increase without clear consideration for public health purposes or in terms of excise revenues (in contrast with the rates provided for NCAs). This fact makes unclear the main underlying goal of the new calendar, i.e. whether it is health or fiscal one.

In view of the expected changes to the overarching European excise legislation on the rates for tobacco products, there is a possibility that the actual Bulgarian rate for cigarettes continues to be around the minimum EU levels (currently it is among the lowest in the Union). Furthermore, in case the local excise tax on cigarettes remains below the future EU-wide minimum rate, Bulgaria may turn out being in a "catch-up" position necessitating future increases in cigarettes rates facing the risk of increased gray market related to the tobacco sector as a result of these increases. Such an effect would have a negative impact both in terms of state revenues and legislative certainty sought by businesses and consumers.

The adopted excise rates include widely differing overall percentage increases for the different types of tobacco products, the reasons for which are not subject to any comments in the motives to the law. Thus, in practice, the rates for products with a perceived lower risk to consumer health (NCAs) are subject to a higher percentage increase than those for more hazardous combustible products. In this regard, to the extent that local rates for NCAs and e-liquids are already above the EU average, it seems logical that any future legislative changes in Bulgaria regarding NCA take this fact into account. Accordingly, a potential "catch-up" increase in the excise duty for cigarettes (if required due to the amended European directive on tobacco products) should not correspond to an automatic increase in the excise duty on NCAs. The taxation of the latter, instead, should be aligned with the minimum rates according to the EU-wide excise duty framework (which is expected to cover NCAs) as well as the already achieved increase in Bulgaria setting the NCAs rates above the average EU levels.

The forthcoming proposal of the European Commission for amendment of the excise directive regarding tobacco products is expected to reflect a new European approach regarding the differentiation of the two main categories of products (smoking products and NCAs), accordingly, the legislative aspects in question should be taken into account when drafting future tax policies in Bulgaria.

III. Possible future legislative measures regarding NCAs taxation

According to the EU Commission, the current Tobacco Excise Directive is unable to cope with the latest developments and emergence of new products on the market such as e-cigarettes

²¹⁹ *Corte Dei Conti, Hearing on the State Estimated Budget for the Financial Year 2023 and Multi-year Budget for the three-year period 2023-2025 (A.C. 643):* [Download \(corteconti.it\)](http://corteconti.it)

and NCAs as a whole. In this regard, we outline several possible areas for future improvement regarding the differentiated taxation of the NCAs.

In this regard, in the current chapter we provide overview of several possible areas for improvement regarding the excise taxation of NCAs.

1. Differentiating NCAs into a separate excise category based on absence of "combustion" process

As a starting point, we consider preferable that NCAs are included into a separate excise category different than those for traditional products and based on the presence/absence of combustion process. This differentiation may be based on several arguments.

First, at this stage there is a prevailing consensus that the method of functioning characterizing the "traditional" tobacco products consumption differs from that of NCAs (this is evident also by the definitions introduced in the Bulgarian EDTWA). Namely, the essential trait of the former is the presence of combustion process (burning). NCAs, on the other hand, have as their main trait the absence of combustion process, i.e., the tobacco or e-liquid is subject to a heating process without being burned. This distinction is also evident in the introduction of a new CN heading 2404 to be used for customs purposes for products consumed through inhalation without combustion. The CN heading 2404, its description and explanatory notes provide an approved and solid conceptual base for consolidating NCAs into a separate group.

Second, the existence of a separate tax category seems preferable from health perspective. Although the health risks from NCAs are still subject to disputes between scholars and NCAs are not risk-free, a significant number of researches demonstrate reduced formation of harmful substances and significantly lower expose of the human body to harm, hence, indicates possibilities for lower risks associated with health when compared to tobacco smoking.

In this regard, a recent paper from scholars from the Johannes-Gutenberg University, Mainz and the Institute for Policy Evaluation, Frankfurt concludes that taxation of non-combustible products could produce two opposite result: (i) it could contribute to overall cessation since the entire market becomes less attractive, if people decide to switch out completely from nicotine products or (ii) it can prevent traditional smokers from substituting combustibles with less harmful products producing a relapse of consumers in favor of combusted products. In this regard a crucial factor is how different prices mutually affect the demand for each product. In case smokers do not quit smoking due to price increases (which is a possible although undesired effect and actually a phenomenon observed in multiple countries), the best subsequent response would be to substitute them with less harmful products. This switching requires that both products are substitutes rather than complements.²²⁰ The substitution may be targeted through their differentiation for tax purposes including in terms of rates. Furthermore, differentiation has the potential of ensuring better future monitoring and analysis of NCAs' consumption and their health impact.

²²⁰ "Tobacco control and optimal taxation in a changing European market landscape," Salvatore Barbaro and Nathalie Neu-Yanders, 30 March 2022.

Third, the creation of a separate tax category seems also logical from economic perspective as it has potential in decreasing the current fragmentation in taxation approaches within the EU. This alignment would contribute to the functioning of the single market as well as enable common movement and monitoring under the EU excise rules (e.g., EMCS).

Finally, the “separation” may support the future innovation in the tobacco sector by shifting the focus of its research and development activities to novel and potentially lower-risk products.²²¹

It should be stressed that, according to a study of the EU Commission from 2020, the introduction of new tax category for e-cigarettes and HTPs is supported by most EU states.²²²

2. Introduction of common taxation principles for NCAs

According to a report of the Commission on the Tobacco Excise Directive, the suggested approach is to tax e-cigarettes not containing tobacco by adopting a harmonized tax category for all kinds of consumables (mainly liquids) to be used with an e-cigarette device with a moderate EU minimum rate per volume of product. The said rate could be reconsidered later when sufficient consensus is reached on the public health profile of these products.²²³

As for HTPs, the recommended approach by the Commission is “per weight” specific structure with inclusion of a minimum rate level.²²⁴ We note that introduction of a minimum rate lower than any product from the combustibles may serve as a stimulus for substitution of combustibles with HTPs or other NCAs. Such substitution, in turn, may contribute to faster decline in smoking prevalence and to reduce the harm from tobacco use (in line with public health objectives).

3. Implementation of gradual taxation calendar

Although seemingly obvious, this aspect should be carefully considered by European and Bulgarian legislators. Taxation of all tobacco and nicotine products (e.g., minimum rates and their increase), similarly to the proposed amendments for energy products, should provide for a gradual increase in the prices without, to the extent possible, increasing the share of the EU illegal market. The existence of such a calendar would also allow for transparency, predictability for businesses and stability for users by introducing phased and balanced increase of rates further aligned with the objective for enabling smooth functioning of the common EU market.

4. Achieving optimal taxation levels

Among the arguments related to the pending revision of the Tobacco Excise Directive is for “risk proportionate” taxation of NCAs. It reflects the standard regulatory practice of imposing burdens considering the risks associated with each type of product. Hence, the most restrictive regulations and higher tax rates are to be applied to the most harmful products (presumably

²²¹ “Evaluation of the legislative framework for tobacco control - call for evidence”, European Tobacco Harm Reduction Advocates (ETHRA).

²²² “Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco”, Brussels, 10.2.2020, p. 41 – 42.

²²³ “Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco”, Final Report - Volume 1, January 2019, p. 12.

²²⁴ Ibid.

combustible products and especially cigarettes) while lower rates are levied on the smoke-free alternatives (presumably causing less harm to users and bystanders).²²⁵

Arguably this point is a controversial one as such an approach may be seen as leading to loss of public revenues or serving the interests of NCAs producers. However, such an approach in the long-term has the potential to impose reduced financial burden on the healthcare system and lead to health benefits for users. Even though the said approach is open to criticism we still deem it worth considering when taking decisions on the optimal taxation levels of NCAs since it combines public fiscal and health policies.

The above cited paper from scholars from Johannes-Gutenberg University, Mainz and the Institute for Policy Evaluation, Frankfurt indicates that higher taxation is usually seen as the only measure to reduce smoking behavior. However, taxation affects users in a differing manner and behaviors of combustible smokers may differ in the event of increased taxation. Thus, one group is not elastic and will accept paying more for smoking, a second group will quit or reduce its consumption while a third group will substitute combustibles with NCAs. The challenge, therefore, when revising the Tobacco Directive would be to adjust the minimum tax levels so that the behavior of more people allows them to fall into the second group (at the expense of the first group), but without precluding the behavioral incentives for falling into the third group.²²⁶ In short, taxation may be designed in a manner pushing consumers toward a reduction in smoking via complete cessation or by switching to less harmful products.

In this regard, increase in the prices of less harmful products may, on the one hand, make them less attractive and limit their market distribution. In addition, consumers of combustibles might be discouraged to switch to less harmful products if these products are taxed heavily. According to the authors, considering the generally accepted findings that NCAs are less harmful, a tax wedge between combustibles and NCAs is preferable to allow the behavioral substitution of combustibles with NCAs. Thus, a well-designed tax on NCAs should be at a relatively lower level to encourage switching from combustibles to NCAs and prevent returning back to combustibles.²²⁷

5. Coherence between excise and customs classifications of NCAs

As commented, tobacco and nicotine products are the only type of excise products which are defined solely by their characteristics and without reference to CN customs codes. According to the Commission, this leads, on the one hand, to subjective criteria in the definitions resulting in legal uncertainty (descriptive phrases such as "without further industrial processing", "consumer expectations", "exclusively intended to be smoked as it is"). Second, this creates dual classification for excise and customs for the same products.²²⁸

²²⁵ "Evaluation of the legislative framework for tobacco control - call for evidence", European Tobacco Harm Reduction Advocates (ETHRA), p. 13.

²²⁶ "Tobacco control and optimal taxation in a changing European market landscape," Salvatore Barbaro and Nathalie Neu-Yanders, 30 March 2022.

²²⁷ Ibid.

²²⁸ "Commission Staff Working Document Evaluation of the Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco", Brussels, 10.2.2020, p. 11.

Having said the above, in a study regarding the Tobacco Excise Directive, the Commission has concluded that this mismatch is not *per se* a problem since the two classifications presumably respond to different needs and objectives.²²⁹

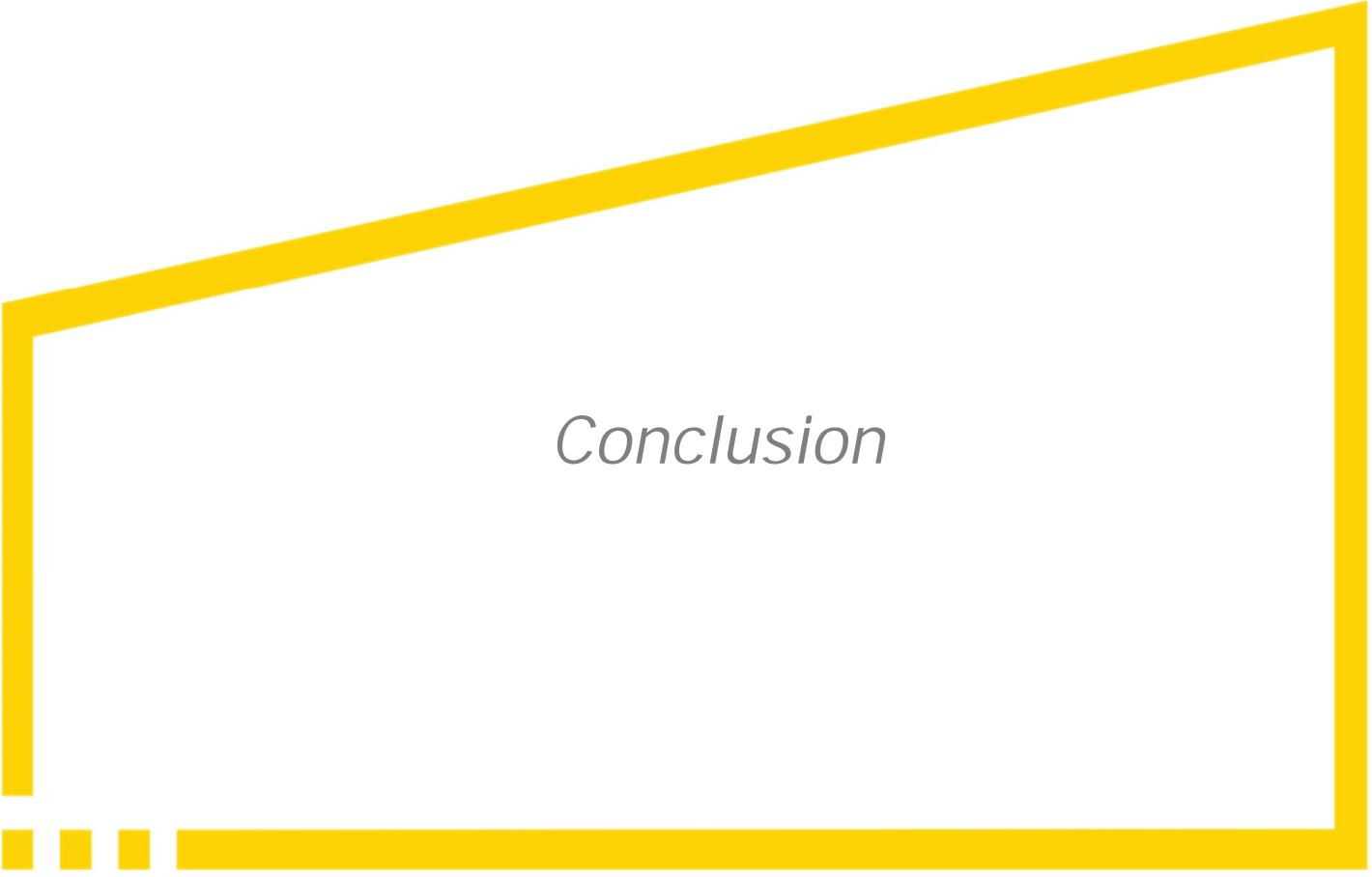
The above conclusion may be questioned in light of the introduction of CN heading 2404 from 1 January 2022 for non-combustible products. This heading would likely cover most of the NCAs products including when such have been previously reported under different headings (e.g., 3824 for nicotine cartridge and refills used for e-cigarettes). Therefore, transposing this heading in terms of the excise taxation of e-cigarettes, HTPs, nicotine pouches and other nicotine products has the potential of ensuring greater alignment between the customs and excise classification similarly to the one existing for alcoholic beverages.

Tobacco consumption is a social issue which entails serious health risks. For this reason, the EU harmonized excise taxation has as its primary goals both protection of public health and ensuring proper functioning of the single EU market. The general assumption is that the health objective may be achieved through higher taxation of tobacco products, i.e., by increasing the applicable EU rates (thus reducing the opportunities for "race to the bottom" taxation).

During the last decade the introduction of novel non-combustible alternatives (NCA) such as e-cigarettes and heated tobacco products (HTPs) has led to the necessity for revision of the EU Tobacco Directive. This revision is also required due to the fragmented approaches applied by different EU states.

Harmonized taxation of NCA may be based on differentiation principle taking into account their specifics vis-a-vis "traditional" tobacco products. The main traits in this regard concerns the lack of combustion process as well as their potential for reducing health risks.

²²⁹ Ibid., at p. 121.



Conclusion

Conclusion

Behavioral economics analyzes economic choices made by consumers and enterprises by also taking into account their imperfect rationality and non-standard preferences. As a trend, the tenets of behavioral economics have had a significant impact on tax policies. This impact is materialized in various taxes aiming to "correct" behaviors and/or improve choices made by producers and consumers for purposes such as public health and environmental sustainability. For this reason, such corrective taxes are evaluated not only through the lens of raised revenues, but also based on their impact on social security and healthcare systems.

Differentiated taxation is a form of fiscal policy leading to imposition of different tax burden on substances or products considered to entail specific negative externality such as risk for human health or detriment to the environment. The different tax burden, therefore, shall ideally be based on the level of harmful component on its own or its amount when it is a component of another product.

As an ultimate goal, differentiated taxation aims to alter the behavior of consumers and prompt innovation on behalf of producers by altering their choices to healthier or less detrimental alternatives (e.g., from producing and using conventional fossil fuels through fossil fuels with certain decarbonization effect to sustainable fuels). Such taxation, therefore, acknowledges that behavioral alteration may occur not only through complete cessation of certain hazardous substance / product usage but also by means of a switch to presumably less harmful substitutes (e.g., from sugar-sweetened beverages to fruit/vegetable juices, from high-alcohol content beverages to spirits with lower alcohol per volume). The existence of such substitutes, therefore, is essential for a tax design aimed at implementing successful differentiation policy (e.g., non-combustibles alternatives to "regular" combustible tobacco products).

The success of differentiated taxation is conditional upon the possibility to distinguish a specific component or product that may be deemed as most dangerous or harmful to human health or environment (e.g., energy content for energy products, presence/absence of combustion process for tobacco and nicotine products, ethanol content for spirits). In addition to this, the outcome of differentiated policies depends on various other factors including, *inter alia*, elasticity of demand. In terms of their characteristics, differentiated taxes are most often ones on consumption, indirect (usually excise but also VAT), levied on single stage (e.g., upon purchase by final consumers) and assessed on a tax base targeting specific hazardous content, substance or product.

Aside from their positive features, differentiated taxes entail specific risks when implemented. Possible downsides may involve presumed imposition of barriers toward free trade, discriminatory practices against certain commodities or economic sectors and even disputable overall health effects (in case of easy substitution with other harmful products). For this reason, a successful tax differentiation policy should take into account not only desirable tax and health/environmental effect, but also possible obstacles and risks for altering human behavior. Therefore, policy making should entail long-term strategy which may include gradual increases of scope and rates, rebalancing weight of different rates, redefining harmful content or products subject to taxation in order to tailor the practical response of both producers and consumers

toward the desired goals. Due to the sensitivities inherent in consumer taxation, major policy-making steps should preferably entail an appropriate clarification by leading subject matter experts as well as wider educational campaigns. Last but not least, differentiated taxation measures should be backed up with regulatory impact assessment which, as a minimum, includes best practices analyses, analysis of their legal admissibility and interaction with other sectoral laws as well as assessment of their overall economic and social effects.

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