

# Differentiated taxation aimed at reducing risks from products with harmful externalities

(Position Paper)



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## Position Paper

Prepared by

Ernst and Young Bulgaria EOOD

*Philip Morris Bulgaria EOOD commissioned Ernst & Young 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.*

# Contents

|  |    |
|--|----|
| <i>Introduction</i> .....  | 5  |
| <i>I. Background and scope</i> .....   | 5  |
| <i>II. Behavioral economics</i> .....  | 6  |
| <i>III. Differentiated taxation</i> .....  | 7  |
| <i>Differentiated taxation – takeaways</i> .....                                   | 9  |
| <i>I. Energy products</i> .....  | 9  |
| <i>II. Food and non-alcoholic beverages</i> .....                                  | 10 |
| <i>III. Alcoholic beverages</i> .....  | 11 |
| <i>IV. Manufactured tobacco and nicotine products</i> .....                        | 12 |
| 1. Tobacco consumption – health and tax considerations .....                       | 12 |
| 2. Categories of tobacco products .....  | 13 |
| 3. Taxation of tobacco products .....  | 14 |
| 4. New Bulgarian excise calendar for increased tax rates of tobacco products ..... | 16 |
| 5. Possible future legislative measures regarding NCAs taxation .....              | 18 |
| <i>Conclusion</i> .....  | 20 |

# Introduction

## I. Background and scope

The current position paper summarizes the main findings from our analysis report entitled "*Differentiated taxation aimed at reducing risks from products with harmful externalities*". The purpose of the cited analysis report is to review and assess the principles of "*differentiated taxation*" applied to several types of products.

The common characteristic of the products within the scope of our analysis is that their usage entails specific "*negative (harmful) externality*," i.e., an activity impacting the human health and/or the environment. The said activity is usually performed by a person, groups within a society or legal entities that influences the same or another person / group without the latter being compensated for the negative environmental or health impact (from the activity).

Our report examines four types of products together with their harmful effects and respective tax policies 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 above products entail specific economic and social characteristics both in terms of their production and usage. The common denominator is that taxation of all four groups is deemed by policymakers as a factor with a significant potential to influence the level of their distribution and final consumption. In addition, taxation measures targeting the usage of the said products are often coupled with public or private incentives for targeted policies and financing (e.g., in the areas of social security, health prevention, informational campaigns, sports activities).

Some of the products are subject to EU-wide harmonized taxation (e.g., energy products and combustible tobacco products) while others have differing tax treatments within EU countries and non-EU states according to internally adopted public policies (e.g., food and non-alcoholic beverages, non-combustible alternatives).

The goal of the current position paper is to summarize the findings in our analysis report regarding differentiated taxation of energy products, food, non-alcoholic and alcoholic beverages, tobacco and nicotine products. Our review and recommendations in the report aim to encompass not only products subject to harmonized taxation within the EU but also ones which are still outside the scope of such harmonization such as NCAs. The latter are currently subject to differing taxations measures among EU countries including Bulgaria.

Based on our research related to the EU-wide legislation regarding traditional combustible tobacco products and specific country approaches concerning NCAs, we are of the view that

future EU-wide taxation of tobacco and nicotine products should take into account the principle of “*tax differentiation*” based on their characteristics. One fundamental difference is the presence or absence of combustion / burning process which leads to differing negative impact for human health. Similarly to differentiated taxation for other products subject to excise duty due to their negative effects, taxation of tobacco and nicotine products should take into account the potential of NCAs to constitute alternatives to traditional cigarettes with reduced health risks for smokers who do not, cannot or are unwilling to quit completely use of tobacco or nicotine as well as for “passive” smokers and bystanders.

The proper assessment of the tax differentiation logic would be incomplete without considering global developments acting as a major impetus for taxation policies. In this regard, during the last decades, both the World Health Organization (WHO) and the United Nations have developed a wide range of policies to support national efforts and fiscal activities aimed at improving public health. For example, the WHO has endorsed the so called “*Global Action Plan*” to support key components of its global strategy for prevention of noncommunicable diseases (e.g., heart disease, cancer, chronic respiratory diseases, diabetes) and targeting major behavioral risk factors such as tobacco use, alcohol consumption, unhealthy dietary habits.<sup>1</sup>

In this respect, in recent years the original revenue-raising objective of tax policies has been increasingly complemented and, in certain cases, even dominated by measures for improving public health and environmental sustainability policies. Among the reasons for this shift is the development of “*behavioral economics*” and its impact on tax policies.

## II. Behavioral economics

Behavioral economics is a combination of psychology and economics that researches markets where agents display human limitations and complications such as specific perceptions determining producers’ and consumers’ behavioral responses. Within the context of taxation, it focuses on “corrective” taxes which seek to achieve targeted changes in human behavior. Therefore, tax efficiency itself is deemed dependent on the extent to which individual consumers or producers react to the levy, and accordingly alter their attitudes and behavioral habits.<sup>2</sup>

The reason for such an approach is that economic choices of households and enterprises often lead to a market failure in the form of under or over-production of a good (from the point of view of maximizing the societal welfare 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 tax policies. Taxes, therefore, may be designed to correct market failures by shifting behaviors toward a desired direction thus acting as a corrective mechanism (e.g., by discouraging or encouraging certain behavioral response). An example for such corrective taxation is the one applied to combusted tobacco consumption whereby higher

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<sup>1</sup> WHO: *Global Action Plan for prevention and control of noncommunicable diseases 2013-2020*, p. 8

<sup>2</sup> “*Implications of behavioural economics for tax policy*”, J. Acheson and Donal Lynch, Irish Government Economic and Evaluation Service, July 2017, p. 1 – 2.

prices are presumed to act as a self-controlling factor that cannot be easily bypassed by smokers.<sup>3</sup>

It is important to note that tax policies based on behavioral economics are not solely aimed at increasing the final prices of the taxed products and raising higher public revenues. Taxation is also used as a tool with broader impact on societal welfare as well as a source of revenue to fund publicly provided goods and services related to limiting the consumption of the harmful goods / activities. Examples include public health services for tackling diseases from alcohol abuse, financing of social security programs based on the principle of "solidarity" etc.

The overall impact from taxes changing behavioral habits may differ depending on the business sector and targeted products. Therefore, taxation policies should be carefully designed, implemented and monitored in order to avoid or mitigate potential negative spill-over effects. For example, while alcohol, tobacco, polluting fuels and unhealthy food consumption may appear as areas where increased tax levels are proper means to achieve health and environmental effects, sharp increases of the taxes may contribute to development of illegal markets thus mitigating or even reversing the desired positive effect. Also, increased taxation leading to reduced consumption may run contrary to the interests of specific segments of the population, geographical regions or whole economic sectors whose main source of income is production and sale of the taxed commodities. Finally, the scope of the taxed products should take into account possible risks of discriminatory policies against certain products, distortion of competition as well as potential substitution on behalf of consumers with other "harmful" products.

### III. Differentiated taxation

By "differentiated taxation" we refer to a taxation based on the logic of behavioral economics. Differentiated taxation provides for a different tax burden of certain product or limited number of products deemed to entail specific negative externality as a major characteristic. The said externality may relate to a risk for the human health, a detrimental environmental effect or even both.

Within this context differentiated taxation may be seen as aiming to influence human behavior in a specific manner by altering the decision-making stimuli for producers and consumers. The said stimuli, on the one hand, may be "negative" such as taxation leading to increased price levels discouraging manufacturing or usage of a specific product. On the other hand, the stimuli may also be "positive" such as by allowing producers and consumers to easily switch to less hazardous alternatives by making substitutes more acceptable and affordable or reducing harm / replacing the percentage or quantity of most harmful contents with less harmful ones.

The said goals are usually targeted by means of taxes which are:

- (i) levied on final consumption (usually on the level of retail sales)
- (ii) assessed as one-off taxes (rather being cumulative)

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<sup>3</sup> "A Behavioural Economics Perspective on Tobacco Taxation," Rajeev Cherukupalli, *American Journal of Public Health*, April 2010, Vol. 100, No 4", p. 612.

- (iii) applied to a limited number of products, which are explicitly differentiated, i.e., are not general taxes on all goods
- (iv) aimed to make the production / consumption of the specific product less desirable from consumers' or producers' perspectives (or both)
- (v) reflect the level of harm/volume of harmful content/substance (e.g., ethanol content in alcohol), or a product where its harmful content is regarded as being higher against such content in a substitute (e.g., conventional fossil fuels versus fossil fuels with decarbonization effect).

The type of tax that most closely corresponds to the above indicative characteristics is excise duty or a tax with a similar profile and mechanism, even when not explicitly referred to as an excise tax.

Having said this, somewhat similar objectives can also be addressed through other indirect taxes such as VAT (e.g., in the form of reduced VAT rate or exemption for specific category of products).

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

# Differentiated taxation – takeaways

## I. Energy products

Historically the EU legislative framework for energy products in the area of excise duties has been based on “economic” criteria which, as a primary objective, aim to ensure the proper functioning of the single EU market. The scope of the products encompasses explicitly defined by their Combined Nomenclature (CN) codes energy products used as motor and heating fuels, natural gas and electricity.

The economic goal has been historically pursued through the setting of minimum excise duty levels as listed in Directive 2003/96/EC of 23 October 2003 restructuring the Community framework for the taxation of energy products and electricity (the so called “Energy Taxation Directive” or simply “ETD”). The minimum rates serve as a “bottom” threshold below which individual Member states are not allowed to tax energy products thus avoiding competition within the EU through introduction of low rates. Other measures for harmonization include specific taxation regimes, common control approaches, special rules and rates for certain activities / sectors (transport, air and maritime logistics etc.).

The existing excise taxation is a volume-based one whereby the rates are determined in accordance with, for example, the kilograms / liters of taxed products. Such taxation is not taking into account the energy content and environmental impact of the products and in practice favors polluting fossil fuels while simultaneously providing little incentives for innovation toward more sustainable products. Therefore, the current excise rules do not ensure the equal treatment of energy products based on their negative externalities (e.g., air pollutants).<sup>4</sup> The consumption of cheaper polluting fossil fuels is further enabled by existence of various incentives for specific EU sectors and industries. Coupled with outdated minimum rates (last updated as of 2010), all these factors lead to necessity for revision of the underlying differentiation principles for energy products.

Based on the strategy of the European Green Deal, the EU Commission has proposed a plan to increase the EU’s binding target to 55% net emission reduction up to 2030. The goals of the Green Deal as well as the increased usage of sustainable fuels have gradually shifted the EU energy taxation to environmental and sustainability goals which should be harmonized with economic growth and development of the EU market. This tendency is evidenced in the “Fit for 55” legislative package part of which is the proposal for new Energy Taxation Directive.

The project for ETD shifts the focus to tax differentiation of energy products based on their harmful nature and externality (polluting effect).<sup>5</sup> In this regard the main differentiation

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<sup>4</sup> Commission staff working document “*Evaluation of the Council Directive 2003/96/EC*”, p. 14-38.

<sup>5</sup> 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).

principle will include setting updated minimum rates based on energy content (expressed in gigajoules) of each product and its environmental performance, rather than solely on its volume. This logic should allow for diversified objectives such as energy efficiency, reduction of greenhouse gas emissions and public revenue generation.

Taxation based on energy content is, therefore, 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 thus acknowledges the specific characteristics of different products. The said goals are also to be achieved through introduction of five categories of energy products beginning with most harmful fossil fuels (subject to highest rates) and ending with low-carbon and advanced sustainable biofuels (taxed with lowest rates).

Other proposed measures involve introduction of transitional period and gradual adjustment of rates (in order to avoid shock pricing effects), annual indexation of rates with inflation, incentives for introduction of novel and cleaner fuels in the aviation and maritime sectors etc.

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.

## II. Food and non-alcoholic beverages

In terms of food and non-alcoholic beverages, the differentiated taxation is usually oriented toward imposition of a levy over a specific content (ingredient) that is deemed harmful or may constitute health risk due to its high content in another product. The tax is thus imposed directly on the volume of the dangerous component or a final product itself containing such a component.

Examples of taxed ingredients include sugar, saturated fats and salt. The taxation of these substances is not governed by harmonized EU rules with different countries both within the EU (France, Denmark, Hungary) and third states (Mexico) adopting specific approaches to address the health problems resulting from their excessive use.

Taxation is usually performed through a tax entailing the specifics of an excise duty, such as being one-off, indirect and levied on the stage of final consumption (by being included in the retail sales price).

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 levy aims to increase the incentives for producers to switch to products with altered content and presumably healthier nutritional composition.<sup>6</sup> Additional potential benefit is the generation of revenue that is subsequently targeted at health promotion purposes and awareness campaigns.

Aside from the positive implications, the introduction of taxes on food and non-alcoholic beverages involves specific risks. For example, as evidenced by the Danish levy on saturated fats, the imposition of “health” taxes is prone to criticism for possibly entailing discriminatory

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<sup>6</sup> WHO: *Fiscal policies for diet and prevention of noncommunicable diseases*, p.20.

taxation against specific products as well as unhealthy substitution with other dangerous products or ingredients.<sup>7</sup>

### III. Alcoholic beverages

By its nature “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. 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).<sup>8</sup>

The production of alcoholic beverages is an important sector within the foods and beverages industry with significant impact on other industries such as retail sales, travel, tourism, restaurant services. The excessive consumption of alcoholic beverages, however, is associated with serious harmful consequences for the health and development of noncommunicable chronic diseases, dangerous societal behaviors and different neuropsychiatric disorders. 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.<sup>9</sup>

Alcohol taxation, therefore, should have both economic and public health goals as it may be used not only for generating public revenues but also for reducing alcohol consumption, accordingly, mitigating the health and societal risks associated with alcohol abuse.

Excise taxes are generally regarded as an efficient instrument to achieve specific pricing policies toward alcoholic beverages. In this regard excise taxation is usually based on one of the following three approaches:

- (i) specific based on ABV content
- (ii) unitary based on volume and
- (iii) ad valorem based on sales price.

The most suitable approach for tax differentiation, to a large extent, is conditional upon the goals targeted by policymakers.<sup>10</sup>

In this regard, the WHO argues that differentiation based on alcohol (ABV) content is the most suitable method to support public health policies and encourage innovation by alcohol producers towards low-strength drinks acceptable for consumers. The rationale behind such an approach is that it generally ignores the historical distinctions between different types of spirits and industries in favor of a more uniform policy taking into account the “harmful” ABV content. The latter, consequently, is the principal factor by which any alcoholic product should be taxed. Similar differentiation is also behind the proposal for amended UK alcohol taxation.

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<sup>7</sup> European Journal of Clinical Nutrition: *The Danish tax on saturated fat: why it did not survive, 2014*; p.224-225

<sup>8</sup> [https://en.wikipedia.org/wiki/Alcohol\\_by\\_volume](https://en.wikipedia.org/wiki/Alcohol_by_volume); accessed on 7 September 2022.

<sup>9</sup> “Global strategy to reduce the harmful use of alcohol”, World Health Organization, p. 3 – 7.

<sup>10</sup> “Alcohol pricing in the WHO European Region – update report on the evidence and recommended policy actions”, World Health Organization, executive summary, p.3.

In terms of EU-wide rules, for about three decades alcoholic beverages have been subject to harmonized legislative framework in the area of excise duty. The main legislative acts in this regard are Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol with its amending Directive 2020/1151 of 29 July 2020 as well as Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages.

Somewhat contrary to the logic outlined by the WHO, the differentiation of the EU excise policy is based on distinctions between alcoholic beverages taking into account the historical evolution of several main tax categories: beer, wine, other fermented beverages, intermediate products and ethyl alcohol. The second main criterion for taxation purposes is the CN code of the product used for customs purposes.

The above differentiation takes into account the existence of highly differing categories of alcoholic drinks the taxation of which presumably should not be uniformly based on a single criterion such as ABV content (leading to unjustified preferential tax treatment of specific product produced with lower ABV without by all means being with lower health risk). In this regard, the main EU-wide approach tackling the health issue from alcohol consumption is the introduction of lower excise rates for lower-strength beverages within a single category (e.g., low-strength beer by volume not exceeding 3.5%).

## IV. Manufactured tobacco and nicotine products

### 1. Tobacco consumption - health and tax considerations

The habit of tobacco smoking has accompanied human history for millenia. According to different studies, currently smoking dependence affects approximately 1.2 billion people across the world which, in turn, impacts various areas of economic and social life including by burdening public health and social security systems and increasing overall health costs.<sup>11</sup>

Among the major global initiatives against tobacco consumption is the Framework Convention on Tobacco Control (FCTC) negotiated under the auspices of the WHO and adopted by the World Health Assembly in 2003. Under the FCTC, states are encouraged to implement tax and pricing policies for tobacco products that contribute to health goals aimed at reducing smoking habits.<sup>12</sup>

In terms of scholarly work and public policies, 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, increasingly and effectively applied during the last years following the introduction of novel tobacco and nicotine products, favors replacing combusted tobacco products for smoking with alternative ones that do not involve combustion and generation of smoke. Price and tax measures are viewed as means for overall reduction of tobacco and nicotine consumption within different segments of the population, especially young people. Thus, while health studies uniformly accept that outright smoking cessation is the best

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<sup>11</sup> *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.

<sup>12</sup> "Electronic nicotine delivery systems" Report by WHO, September 2014.

possible solution, there is a growing body of scholarly work focused on efforts advocating the shift from tobacco smoking to presumably less harmful products. Tax differentiation policy is thus an useful tool accompanying and complementing the already established methods for taxation of tobacco and nicotine products.

The mentioned body of work acknowledges that complete smoking cessation, although desirable from health perspective, is a difficult task. Various scholarly studies conclude that nicotine is not the primary cause of smoking related diseases, therefore, nicotine substitution therapies are widely accepted within the health community as a suitable approach for tobacco cessation. The provision of effective and affordable substitutes to combustible tobacco may generate health benefits by allowing smokers to reduce harm by eliminating “tobacco smoke” without fully ceasing the nicotine usage.<sup>13</sup>

The said view is supported by certain studies such as the one conducted by the European Tobacco Harm Reduction Advocates (ETHRA). In the said study, the ETHRA argues that nicotine is not the main cause of health problems among smokers but rather the inhalation of constituents occurring during the combustion process, i. e., toxic chemicals released during the burning of a cigarette. Tobacco harm reduction policies, therefore, may aim not only at smoking cessation but also at reduced harm by enabling the substitution of the most harmful tobacco products with less harmful ones (such as NCAs).<sup>14</sup>

In light of the above, research in recent decades has focused on examining substances and elements contained in the emissions of different forms of tobacco use, which may constitute a basis for risk stratification from health perspective, i.e., an approach based on risk profile.

The said risk differentiation is still subject to disputes as, according to the EU Commission, there is an ongoing scholarly debate on the ultimate health impact from novel tobacco products and their long-term harmful effect to human health.

Having noted the above, health considerations continue to be inseparable from the excise taxation of tobacco products. In this relation, from its onset, the EU tobacco excise legislation has been explicitly aimed at achieving a dual goal by ensuring both functioning of the internal market (economic goal) and human health protection (public health goal). The European legislative framework, therefore, is supposed to discourage tobacco smoking deemed as the most harmful way of tobacco and nicotine consumption, through measures such as reduced availability of cigarettes and tobacco (e. g. by increasing the prices of tobacco products, banning or restricting sales of duty-free and tax-free items).<sup>15</sup>

## 2. Categories of tobacco products

For taxation purposes we distinguish between two basic categories of manufactured tobacco and nicotine products.

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<sup>13</sup> “Polosa et al.: A fresh look at tobacco harm reduction: the case for the electronic cigarette.” Harm Reduction, Journal 2013; p.1.

<sup>14</sup> “Evaluation of the legislative framework for tobacco control – call for evidence”, European Tobacco Harm Reduction Advocates (ETHRA).

<sup>15</sup> “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.

On the one side are the traditional “*combustible tobacco products*” for smoking which for decades have been subject to harmonized excise legislation within the EU (cigarettes, cigars, cigarillos and smoking tobacco). The said combustible products are within the scope of Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco (“the Tobacco Excise Directive”). It should be pointed out that, unlike other excise goods (energy products and alcoholic beverages), tobacco products are the only excise category not containing references to CN codes but based only on written descriptive definitions.

The second major category in our analysis involves novel “*non-combustible tobacco and nicotine alternatives or NCAs*.” The said products are still not subject to EU harmonized taxation rules but are taxed based on individual policies within Member State including Bulgaria. These products most notably include the most widely used e-cigarettes and heated tobacco products but also “niche” goods such as smokeless tobacco products and nicotine pouches.

The main differentiation criterion between the two groups is the presence or absence of combustion process (burning) upon their usage. In this regard, while the traditional products are inextricably linked to a combustion, the NCAs are characterized with a lack of such a process and, instead, involve heating process of tobacco (HTPs) or nicotine liquid (e-cigarettes).

### 3. Taxation of tobacco products

The excise tax policies may be distinguished based on whether they relate to combustible products or NCAs.

#### (A) Combustible products

The harmonized EU legislation sets common minimum rates while the EU states are free to apply excise duty rates above the minimal ones and in accordance to their own national needs.

The minimum rate for the most widely used combustible product, namely cigarettes, consists of two components: (i) “specific” calculated as a fixed amount in EUR per 1000 cigarettes and (ii) “ad valorem” calculated as a percentage of the retail sales price. The two components may be applied by Member states provided that the total minimum (i.e. overall excise rate) is at least EUR 90 per 1000 cigarettes and 60% of the weighted average retail selling price.

As for the other products, the EU minimum rates are:<sup>16</sup>

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

<sup>16</sup> “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.

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

As of the beginning of December 2022 the excise rates for cigarettes in Bulgaria are: (i) specific - BGN 109 per 1000 cigarettes; (ii) ad valorem (proportional) - 25% of the selling price and (iii) total minimum excise rate - not less than BGN 177 per 1000 cigarettes.<sup>17</sup> The Excise Duties and Tax Warehouses Act (EDTWA) provides for the following rates for other combustible products: (i) tobacco for smoking (for pipes and cigarettes) – BGN 152 per kilogram (unified specific rate per kilogram)<sup>18</sup> and (ii) cigars and cigarillos – BGN 270 per 1000 items (specific rate per number of pieces).<sup>19</sup>

In light of the above, the Bulgarian total minimum rate for cigarettes (EUR 177) is equal to the EU total minimum rate. On the other hand, the Bulgarian rate for smoking tobacco (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).

The above model of taxation in practice leads to high tax burden applied on less common products (cigars, cigarillos and smoking tobacco) and low tax burden on the most widely used tobacco product (cigarettes).

#### (B) Non-combustible alternatives (NCAs)

The taxation of the NCAs is subject to differing approaches among EU 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.<sup>20</sup>

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. 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.<sup>21</sup>

The average rates 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.<sup>22</sup>

In Bulgaria the liquids for e-cigarettes containing nicotine will be included within the scope of excise goods effective from March 2023.

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<sup>17</sup> Article 39 of the EDTWA.

<sup>18</sup> Article 38 of the EDTWA.

<sup>19</sup> Article 37 of the EDTWA.

<sup>20</sup> "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.

<sup>21</sup> *Ibid.*, at p. 41-42.

<sup>22</sup> "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.

- Heated tobacco products (HTPs)

The HTPs are already 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 (thus treating HTPs as smokeless products or non-combusted products, hence, a special excise tax category, different than smoking tobacco products) with setting the rates around the level of "other smoking tobacco" harmonized category.<sup>23</sup>

Most of the countries tax the HTPs by tobacco mixture weight, i.e., per kilogram. Some exceptions include Latvia and Hungary, which tax by unit (stick) and Portugal which has a mixed specific (based on tobacco mixture weight) and ad valorem regime (as a percentage of the retail selling price). The EU rates vary significantly.<sup>24</sup>

The HTPs are included within the scope of the Bulgarian EDTWA in 2017 by determining, like majority of the EU states, the tax base as the weight of tobacco contained in the product measured per kilogram. The initial tax base was BGN 152 per kilogram (same as the one applied on tobacco for smoking) and increased from 2018 to BGN 233 per kilogram.

#### 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 1000 short, 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%

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<sup>23</sup> "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.

<sup>24</sup> Study on Council Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco", Executive Summary, p. 10.

- 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 different risk profiles of NCAs compared to traditional 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).<sup>25</sup> 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 that the level of excise duties should have a correspondence with the extent of the social damage caused by the consumption of these products."*<sup>26</sup>

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 minimum 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, with 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 the more hazardous combustible products. In this regard, to the extent that local rates for NCAs and e-

<sup>25</sup> Austria: [Budgetbegleitgesetz 2023 – BBG 2023 \(1776 d.B.\) | Parlament Österreich](#) Romania: [Legea nr.227/2015 \(anaf.ro\)](#)

<sup>26</sup> 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 \(corteconti.it\)](#)

liquids are already above the EU average, it would be 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.

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

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

We consider preferable that the NCAs are included into a separate excise tax category different than that for traditional tobacco products for smoking and based on the absence of combustion process. One reason is that the main characteristic of traditional tobacco products is the combustion (burning) process, which is missing in the NCAs (characterized either with a heating process or whereby their usage does not require any thermal process). From tax perspective such differentiation also has the potential to reduce the current fragmentation of taxation approaches within the EU.

- 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.<sup>27</sup>

As for heated tobacco products (HTPs), the recommended approach by the Commission is "per weight" specific structure with inclusion of a minimum rate level. Such a minimum rate, lower than that for combustibles, could serve as an incentive for substitution away from combustibles.

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<sup>27</sup> "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.

- Implementation of gradual taxation calendar

The taxation of NCAs (e. g. minimum rates and their increase) may provide for a gradual increase in prices without, as far as possible, increasing the share of the illegal EU market.

- Achieving optimal taxation levels

Preferably, EU-wide harmonized taxation of the NCAs should be based on the principle of differentiation, taking into account their specifics vis-à-vis “traditional” tobacco products for smoking. As noted, a main feature is the absence of a combustion process as well as the possibility for reducing health risks associated with smoking. While the latter aspect is still a contentious issue among scientists, we consider that it nevertheless may be taken into account when deciding on the optimal levels of taxation for NCAs as well as where the taxation levels for NCAs are subject to future updates.

- Coherence between excise and customs classifications of NCAs

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 European Commission this leads, on the one hand, to subjective criteria in definitions resulting in legal uncertainty. Second, this creates dual classification for excise and customs for the same products.<sup>28</sup>

The above lack of coherence may be addressed following the introduction from 1 January 2022 of CN heading 2404 for non-combustible products. This heading would likely cover most NCAs products including when such have been previously reported under different CN headings. Therefore, transposing this heading in terms of excise taxation of e-cigarettes and HTPs has the potential of ensuring greater alignment between the customs and excise classification as well as legal certainty (similarly to the one for alcoholic beverages).

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<sup>28</sup> “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.

# Conclusion

When applied to tax policies based on differentiation criteria, the main tenets of behavioral economics may influence the behaviors and/or improve the 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 in terms of increased public revenues, but also on the basis of their impact on social security and health care systems.

Differentiated taxation, therefore, is a form of taxation 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.

As an ultimate goal, differentiated taxation may aim not only at complete cessation of a harmful activity but also toward enabling stimuli for altered consumption habits of final consumers and innovation on behalf producers aimed at shifting toward potentially less detrimental alternatives (e.g., from sugar-sweetened beverages to fruit/vegetable juices, from high-alcohol content beverages to spirits with lower alcohol per volume, from combustible tobacco products to non-combustible alternatives).

The existence of carefully structured taxation policies toward such substitutes, therefore, is essential for a tax design aimed at implementing successful differentiation policy for products with differing levels of harmful externalities.

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