

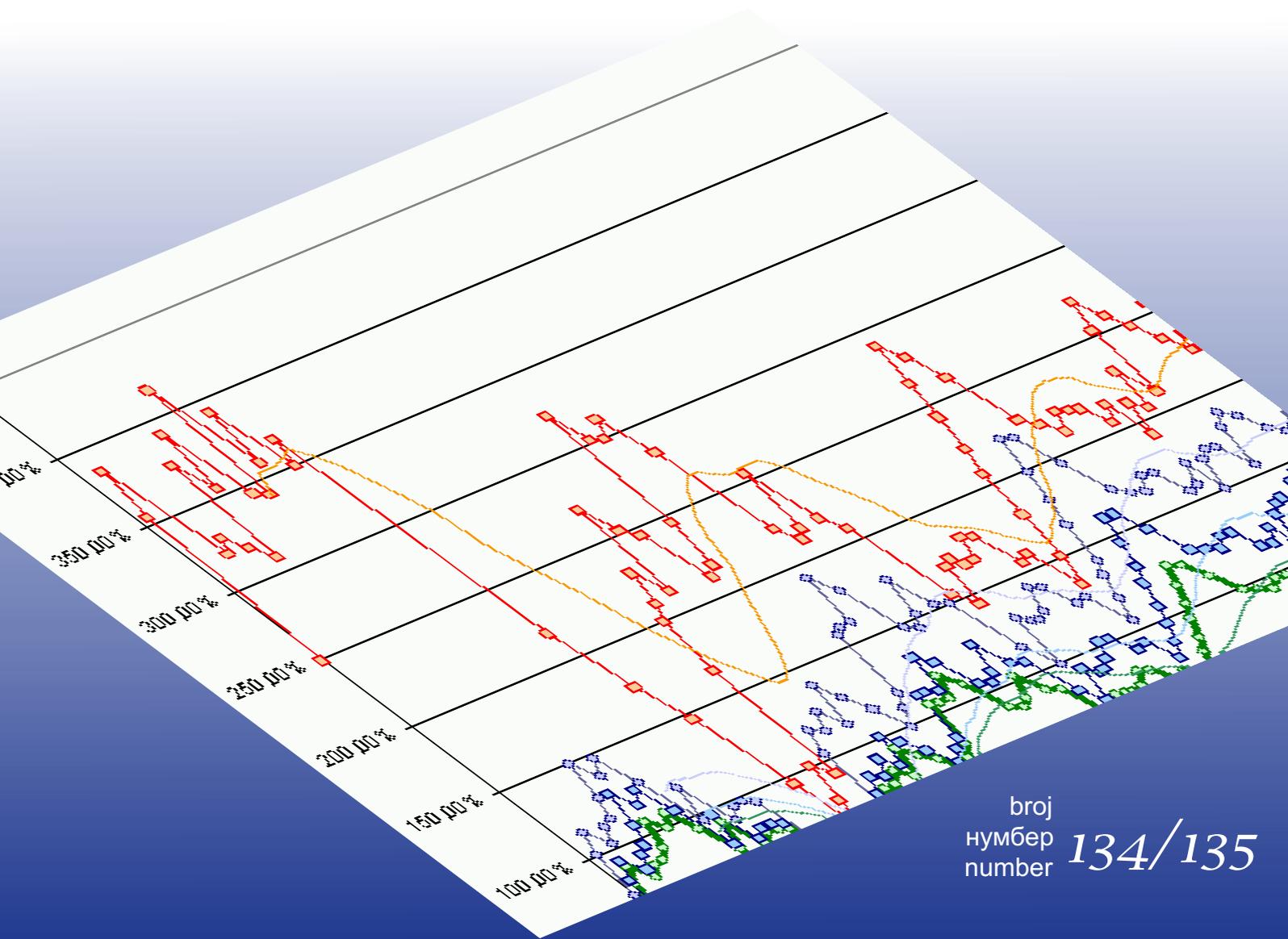
Bosna i Hercegovina  
Odjeljenje za makroekonomsku analizu  
Upravnog odbora Uprave za indirektno-  
neizravno oporezivanje



Босна и Херцеговина  
Одјељење за макроекономску анализу  
Управног одбора Управе за indirektno-  
неizravno опорезивање

Macroeconomic Unit of the Governing Board of the Indirect Tax Authority

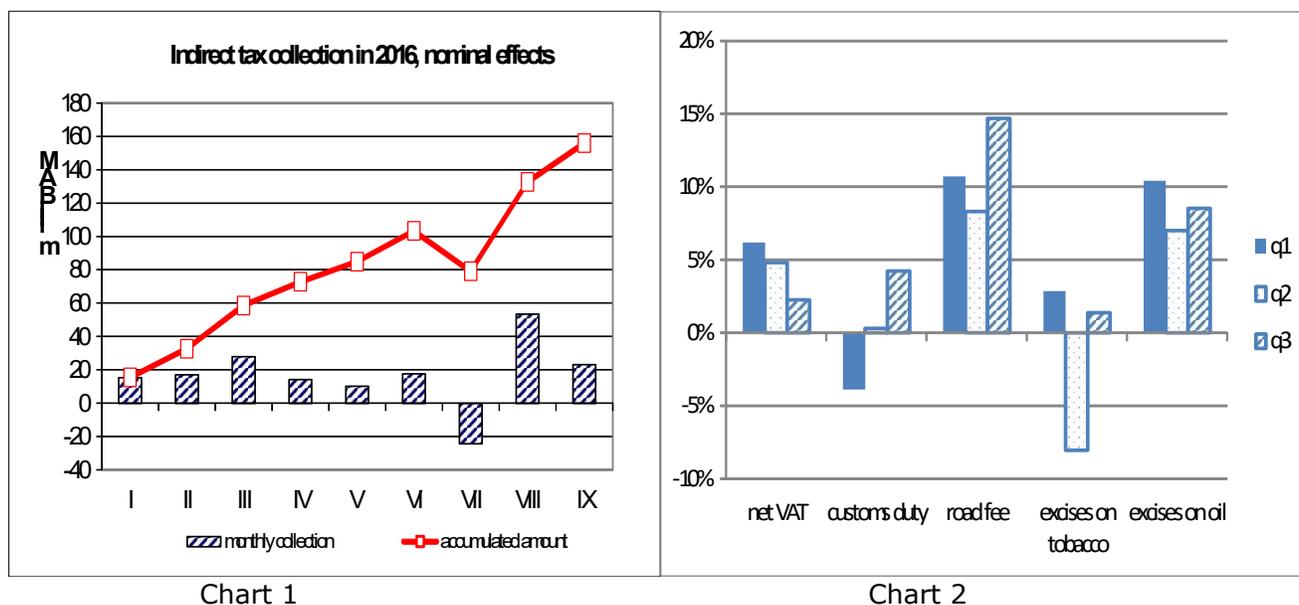
# *Oma Bilten*



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## With this issue

According to the preliminary cash flow report on the ITA SA, it was collected in September 597 million KM of gross revenues from indirect taxes or 22,6 million BAM more than in the same month of 2015. Since the refunds were around the 2015 payments, the net revenue growth amounted to 23,1 mil BAM (Chart 1) or 4,8% more than in September 2015. The positive trends in September led to an increase in the cumulative surplus at the period January - September. Total gross collection amounted to 4,865 billion BAM, representing an increase of 146,7 million or 3,1%. Reduction of refunds contributed to the growth of cumulative net surplus to 155,8 million BAM (Chart 1), representing an increase of 4% in comparison with nine months 2015.



Observation by types of revenues for the nine months of 2016 shows the highest growth in revenues from excises and road taxes, a total of 47,8 million KM, and from VAT of 103,2 million BAM. It should be noted that, according to the preliminary report, it was recorded an additional 22,3 million BAM of unadjusted revenues, which have not yet been allocated by type. Quarterly comparisons show divergent trends in revenue collection during the year (Chart 2). The growth in the first and second quarter was generated by revenues from VAT and excises on oil and road taxes.

The third quarter of 2016 finally brought the moderate increase in customs revenues and revenues from excises on manufactured tobacco. The Bulletin also provides an annual analysis of effects of the new policy of excise duties on manufactured tobacco in B&H on revenues and consumption of tobacco in the period August 2014 – December 2015.

Dinka Antić, PhD  
Head of Unit

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## The effects of the new policy of excise duties on tobacco products in B&H

(Author: Dinka Antić, PhD)

*This article follows the analysis of the effects of amendments to the Law on Excise Duties (in force since 1 August 2014), published in the Bulletin no. 114 and other bulletins published during 2015.*

### INTRODUCTION

The new policy of taxation of tobacco products applies from 1 August 2014. The new policy includes the following:

- Taxation of fine cut tobacco with the specific excise duty,
- Tying the excise duty burden on fine cut tobacco to the growth of excise duty burden on cigarettes,
- Determination of the minimum excise duty on cigarettes according to the weighted average price of cigarettes and
- Increase in the minimum excise burden on cigarettes to the level of the minimum excise duty in the EU.

Fiscal authorities aimed to achieve two goals by adopting the new tobacco taxation policy:

- To eliminate unadjusted policy of taxation on cigarettes which led to the erosion of revenues from excise duties and distortions in the market of tobacco (strengthening black-marketing, smuggling, illegal cigarette production);
- To harmonize standards of tobacco taxation with the current EU standards.

Considering the scale of tax evasion in the tobacco market, appeared in 2011 and culminated in 2013, it can be said that the first objective of the new excise policy is also the primary objective and the second objective was used for the development of technical platform for deployment measures of the new excise policy in B&H. New technical standards in taxation of tobacco products include:

- The introduction of weighted average price of cigarettes as a reference price for determining the minimum excise duty and
- An increase in the minimum EU standards, of which the most important for B&H is nominal minimum excise duty on cigarettes in the amount of 90 EUR/1000 cigarettes.

### TRENDS PRIOR TO CHANGES OF THE LAW (2009-2013)

The new Law on excise duties in B&H from 1 July 2009 passed the initial introduction of the specific excise duty on cigarettes in the amount of 0,15 KM/pack. Under the provisions of the Law in the following years the specific excise duty on cigarettes is supposed to be continuously increasing minimum 0,15 KM/pack per year, until the total excise burden reaches 126 KM for 1000 cigarettes<sup>1</sup>. *Ad valorem* excise duty in the amount of 42% of the retail price on cigarettes is retained. Other tobacco products (cigars, cigarillos, smoking tobacco) are taxed only with *ad valorem* excise duty of 42% calculated on the retail price of cigarettes.

Tax increase in the retail price structure (specific excise duty + corresponding part of VAT) as expected brought growth in retail prices, although tobacco companies sought to alleviate "tax

<sup>1</sup> It is a minimum excise duty on cigarettes in the EU (64 EUR/1000 pieces) that was in effect at the time of enactment of the Law.

shock" on prices by shifting additional tax at expense of profit. However, given the low price before taxation, there was not a lot of maneuver room to ease rising prices, especially by the domestic tobacco industry. Although the new Law was passed in the midst of the global economic crisis the cigarette market could absorb the continuous rise of the tax in prices (excise duty + VAT) until 2013. The largest growth in the cigarette market value was recorded in 2010 (18,2%) but then there was a sharp slowdown in 2011 and 2012 (6,4% and 2,4% respectively). By 2013 the market of fine cut tobacco was negligible, but then it increased by as much as 350%. The reason for this was moving the "endurance threshold" of consumers, who, further rise in the excise burden, and consequently, in retail prices of cigarettes, avoided by switching to the rolling of cigarettes from cut tobacco.

The extent of substitution of cigarettes with cut tobacco was much larger than it was showed by data on growth of cut tobacco market, because the market of illegal unbranded tobacco from domestic production and smuggling exploded<sup>2</sup>. Such trends have devaluated the official health statistics, which showed that consumption of cigarettes in 2013 fell by 20,6% compared to 2012. However, as the reason for such a sharp drop in consumption was not consumers' giving up smoking, but switching to rolled cigarettes from cut tobacco, mostly of poor quality, health policy objectives in terms of reducing smoking were not only met but were completely derogated.

It was normal to expect that the process of harmonization of excise duties with the minimum EU standards would bring a drop in cigarette consumption. Based on the research of more than a hundred studies on the behavior of cigarette consumption in the terms of tax increases in the last fifty years economists have concluded that in most countries the elasticity was -0,4. On the other hand, the analysis of the World Bank shows that the price elasticity is greater in less developed countries, and that in the case of cigarettes it goes up to -0,8<sup>3</sup>.

Within the period 2009-2012 the elasticity of cigarette consumption in B&H is steadily increasing, from acceptable -0,4 to -0,8. In 2013, due to strong substitution of cigarette consumption the elasticity has escalated. The main reason for such negative trends is the gap in the tax burden of cigarettes and fine cut tobacco which is a substitute for cigarettes. Of course, in this case it is the substitution of the cheapest industrially manufactured cigarettes with cigarettes manually rolled of cut tobacco. It can be assumed that during the increase in retail prices, consumers with the lowest income are first to give up from cigarette consumption, while structural changes occurred in the structure of other consumers. Consumers from middle income groups switch to cheaper cigarettes, while consumers with high incomes because of their status retain consumption of expensive cigarettes. Therefore, it can be concluded that the price elasticity of cigarette consumption is not a homogenous category and that depends largely on the structure of consumers. B&H has a polarization between domestic (mostly cheaper) and imported (mostly more expensive) cigarettes. The fact that consumption of domestic cigarettes in 2013 fell by 28% compared to 2012, and imported by 16,8% indicate that the process of substitution of cigarettes with cut tobacco to a greater extent hit the domestic tobacco industry because of higher attrition of consumers with lower incomes.

In the first years growth of excise rates ensured growth in total excise revenues regardless of the drop in consumption. At the beginning high growth rates in revenues from excise duties were recorded, particularly in 2010, when revenues due to lower base increased by 37,1%. From 2011 growth was slowing down and a decrease of 4,1% was recorded in 2013.

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<sup>2</sup> More in\_ Antić, D., 2014. „Trends in collection of revenues from excise duties on tobacco: from the revenue "boom" to tax evasion". *MAU Bulletin* No. 104/2014.

<sup>3</sup> More in: Antić, D., 2015. „Implications of the taxation of tobacco in the European Union in the period 2005-2014". *Financial Theory and Practice*, 39(3) 279-304. Institute for Public Finance, Zagreb.

The main cause of loss of revenues from excise duties is differentiated taxation of cigarettes and fine cut tobacco at the expense of cigarettes. In the first years the gap in the tax burden was not so significant for consumers to give up from cigarettes and to switch to cut tobacco. However, as rates on excise duties were growing only on cigarettes and not on cut tobacco, the gap in the tax burden was getting bigger. Chart 1 shows the simulation of the tax burden on cigarette package obtained from 1 kg of tobacco (taking into account the norms of manual cigarette production) and the package of the cheapest industrially manufactured cigarettes which cost 1KM at the time of entry into force the new Law on Excise Duties (1 July 2009).

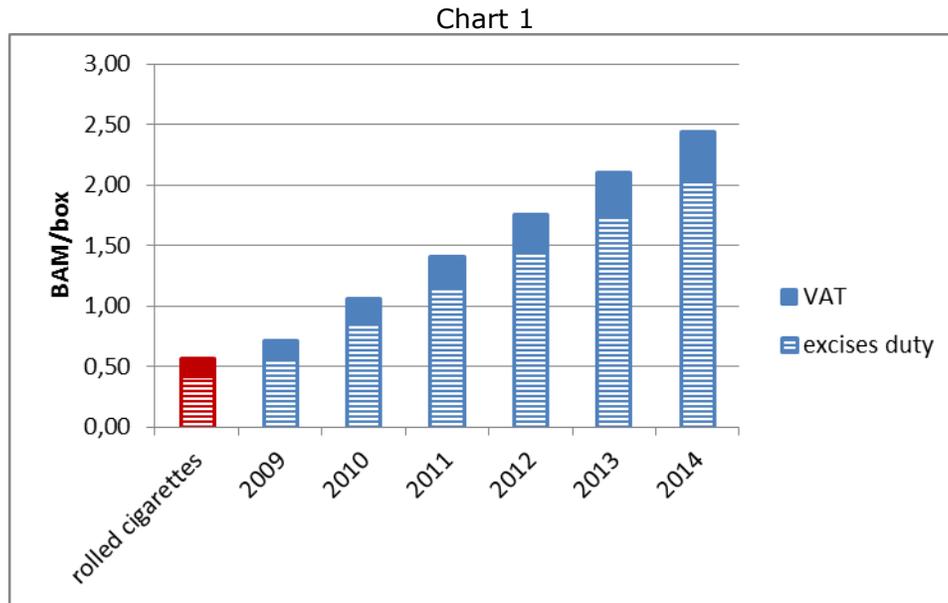


Chart shows an increase in the tax burden and cigarette packs by 2014. Continuous increase in the specific excise duty on cigarettes brought a strong growth in the tax burden on cigarettes, which is further increased because of an increase in the VAT amount due to the higher basis. Since the excise burden on cut tobacco remained unchanged throughout the period, the gap between the tax burden on cut tobacco and cigarettes grew from year to year. In 2014 total taxes included in the pack of the cheapest cigarettes were almost five times higher than in the pack of cigarettes obtained by rolling cut tobacco.

### TRENDS AFTER CHANGES OF THE LAW (2014-2015)

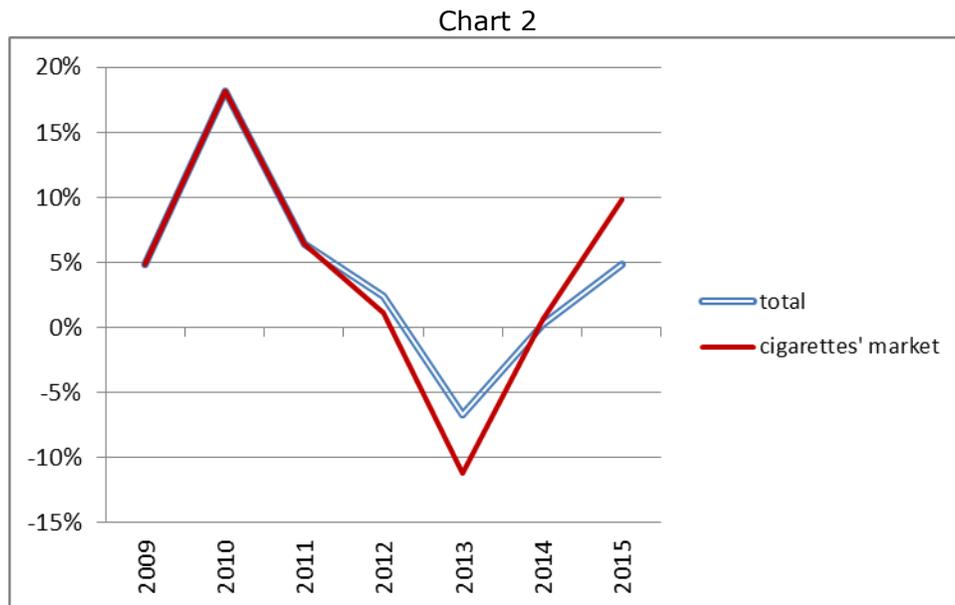
Harbingers of significant changes in the tobacco market occurred immediately after the adoption of the amendments to the Law on Excise Duties and prior to their entry into force (1 August 2014). The introduction of the specific excise duty has increased the tax burden on kilogram of fine cut tobacco by 212%, and total tax burden (excise duty + VAT) by 184%. The drastic increase in the excise burden on cut tobacco urged its accumulation, as brand taxed tobacco so the unbranded untaxed as well. After the entry into force of amendments to the Law there were significant positive changes. In just four months, the cumulative consumption of domestic taxable cut tobacco is reduced to the level of 2013 and the amount of imported cut tobacco has been reduced by 32%.

#### *The value of the market of tobacco products*

Large tax evasion in 2013 led to the decline in value of the cigarette market by 11,2%. At the same time, due to the shift of smokers to brand cut tobacco, value of the legal market of cut

tobacco has quadrupled. It is significant amount indicated by the fact that the substitution of cigarettes with branded cut tobacco alleviated fall in the value of the tobacco products market, which dropped by 6,7% in contrast to the segment of cigarettes (Chart 2). The new excise policy brought a reversal in just five months. According to data for 2014 the value of the cigarette market increased by 0,7% while the value of the cut tobacco market decreased by only 6,8% thanks to large procurements before the entry into force of amendments to the Law. Due to events in the segment of fine cut tobacco the total market of tobacco products in 2014 increased by modest 0,3% compared to 2013.

Positive trends, as a reflection of the measures of the new excise policy, continued in 2015 as well. Despite the growth of the specific excise duty on cigarettes and specific excise duty on fine cut tobacco total market increased by 4,8%, reaching the level of 2011 but not of 2012. Analysis of the structure of tobacco products market indicates that the growth of the cigarette segment amounted to 9,9%, while the fine cut tobacco segment fell by as much as 81%, in nominal terms at the level of 2012. Although the value of domestic market of cigarettes in 2015 increased by as much as 24,5%, it is still far below than in 2011 and 2012. On the other hand, the market value of the imported cigarettes exceeded the previous peak from 2012, although it grew at a more moderate rate of 5,3%.

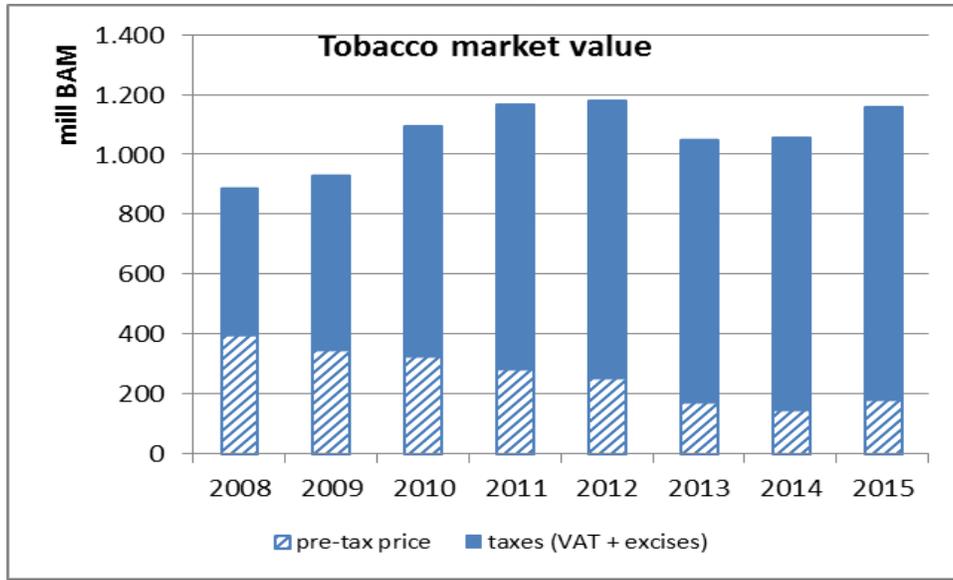


The growth of tobacco products market can be explained by:

- (i) Measures of the new excise policy,
- (ii) Operational measures of the ITA and other State and Entity institutions to combat smuggling, trafficking and illegal production and sale of cigarettes, and
- (iii) The growth of aggregate consumption.

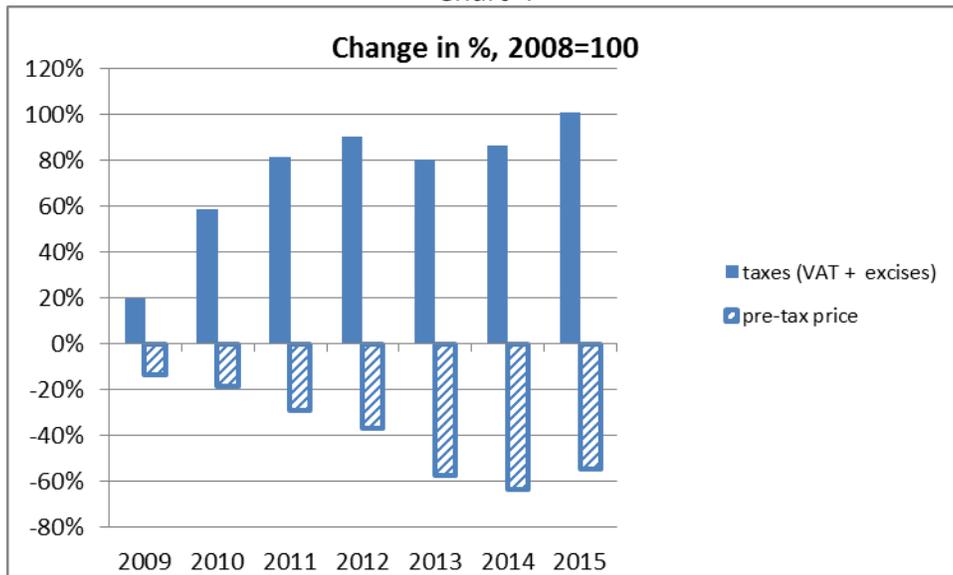
In any case, the structure of sale was also improved, in terms of the price growth before taxation (which includes profit/margin) and the part relating to tax benefits (Chart 3).

Chart 3



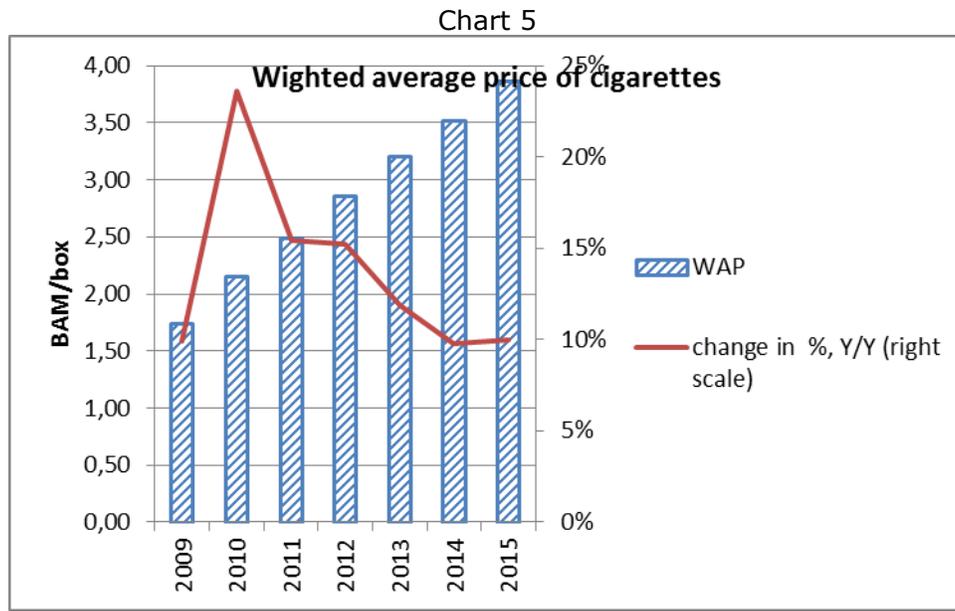
Steep drop in share prices before taxation in 2015 has been stopped but the total income of the tobacco industry is still under 50% of revenues from 2008, while the collected taxes (VAT and excise duties) are doubled compared to 2008 (Chart 4).

Chart 4



*Retail prices of cigarettes*

Continuous increase in excise duties on cigarettes brought a rapid increase in the average weighted price of cigarettes. Compared to 2008, the average weighted price has increased by 144%. The biggest rise was recorded in 2010 due to the implementation of the new Law only in the second half of 2009. The slower growth comes later, in the first place due to the high base for comparison (Chart 5).



In 2012, the average weighted price of cigarettes was by 0,03 KM/pack above the expected increase of price due to increasing excise duties. However, in the next two years, under the pressure of tax evasion and fear of radical reduction of the market, tobacco companies are not entirely shifting new tax burden to consumers, but they partially go at the expense of their own profits, 0,01 KM/pack in 2013, and 0,04 KM/pack in 2014. Analysis of the structure of cigarettes in 2014 shows that domestic companies on average bore even 0,06 KM/pack at the burden of their own profit.

After a turbulent year of 2014 amendments to the Law on Excise Duties brought stabilization in trends in 2015. Finally, total additional tax burden is completely shifted to the customer in both domestic and imported cigarettes. However, developments in 2015 show different business policies and adapting companies to the market situation. Both domestic companies and importers in the first months held prices below the expected level bearing a share of the tax at the burden of profits.

Chart 6 shows that the importers quickly abandoned such policy and that they have significantly increased prices, trying to compensate losses from the first two months. Domestic companies have kept prices below the expected level, while suffering losses, until June 2015. December was interesting because the average weighted price of imported cigarettes was significantly below the expected one. It points to a policy of increased placement of cheaper cigarettes prior to the new increase in excise duties, which then brought down the average weighted price in that month.

Chart 7 shows dramatic changes in the structure of the weighted average price of cigarettes in terms of growth of excise duties and VAT, whose share increased by 122% in 2015 compared to 2009, while the price before taxation increased by only 4%. The above developments indicate that brands with low retail price have the largest weight.

Chart 6

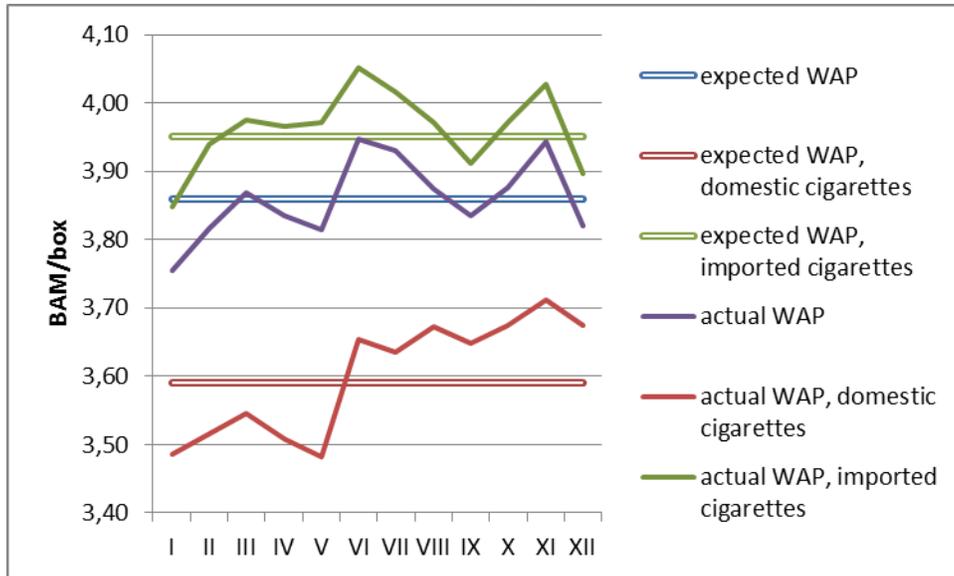
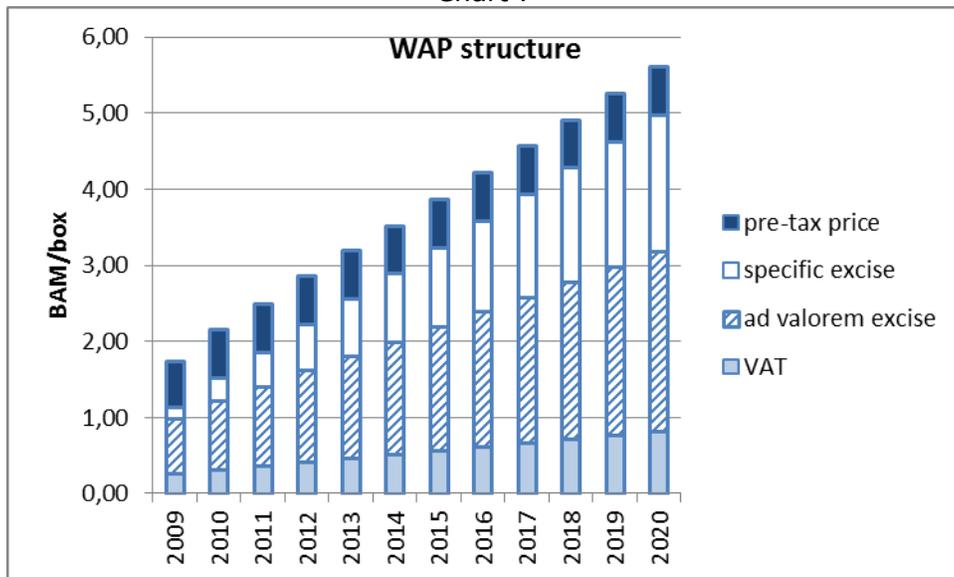


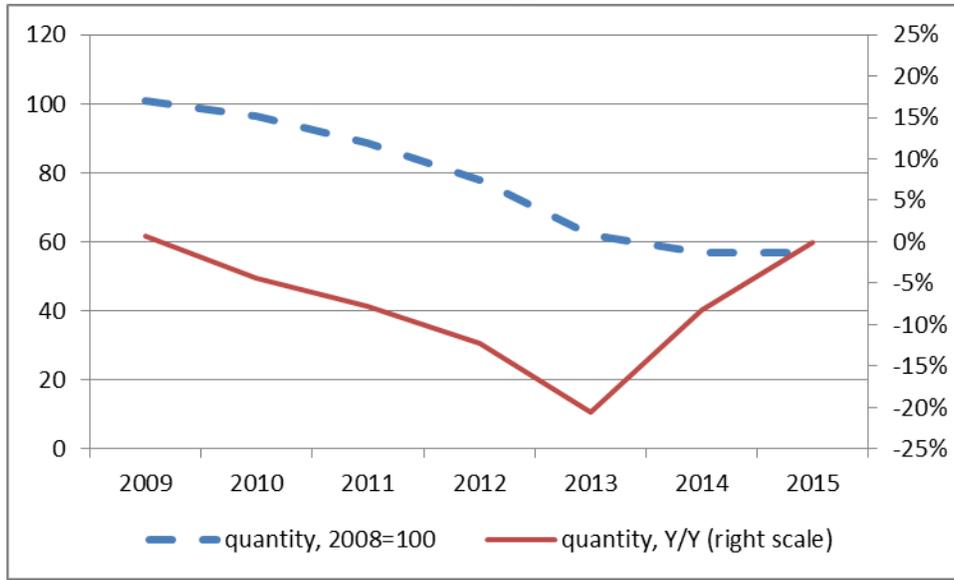
Chart 7



*Consumption of tobacco products*

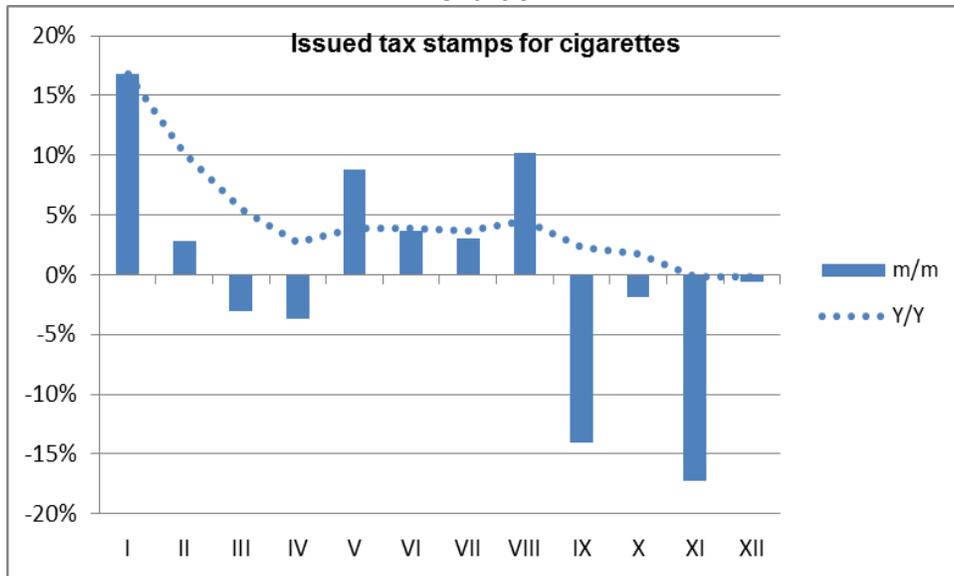
From the above analysis it can be concluded that the measures of the new excise policy led to an increase in the market values which were allocated in the structure to the part that is left to companies (price before taxation) and to the part of tax benefits. The value of the market is in the function of two variables: price and consumption. In 2015, a new excise burden is entirely shifted to retail prices. However, regardless of that fact, contrary to the theory of elasticity in taxation and research practices in countries around the world, the price increase did not bring a drop in cigarette consumption. On the contrary, instead of falling, consumption of cigarettes, measured by issued excise stamps, maintained at the level of 2014. It also amounts to only 54% of the amount from 2008 (Chart 8).

Chart 8



On the other hand, consumption of brand fine cut tobacco decreased by 80,6% compared to 2014. It is obvious that the large increase in retail prices of cut tobacco and measures to combat illegal production and sale of cigarettes discouraged consumers to buy cut tobacco, so they have turned to cigarette consumption. Having this in mind, trends in cigarette consumption in 2015 can be considered as the exception or one-off effect of the excise policy changes. This is indicated by the monthly issuance of excise stamps for cigarettes in 2015 (Chart 9). Due to uneven distribution of the effects of amendments to the Law the increase in the amount of stamps was recorded in the first eight months of 2015, and in the rest of the year a fall was recorded of even over 15% (September and November). The reason for the drop is higher statistical base from the second half of 2014 which included the initial effects of implementation of the new tax policy, but probably the decline in aggregate consumption and disposable income for consumption as well.

Chart 9



### Revenue from excise duties

New trends in the tobacco market in B&H have brought the growth of revenues from excise duties (Chart 10). In the last five months of 2014, a growth in revenues of 15,8% was achieved, which was enough to compensate for losses from the previous part of the year and to achieve the annual growth of 4,3%. However, in nominal terms the amount of revenues is returned to the level from 2012 which represented a historic maximum. Positive trends in the collection of excise duties were continued in 2015 as well. There has been a growth of 7,1% and the overall level of revenues from excise duties has surpassed the collection from 2012 for 53,2 million KM (Chart 11).

If we analyze the structure of excise revenues (domestic/import companies) we can conclude that domestic excise duties in 2015 grew at a rate of 14,7% and the import of 4,3% compared to 2014. However, if we compare the collection with 2012 the situation is reversed, domestic excise duties grew only 0,9% and import 9,7%. In the structure of losses in excise revenues in 2013 out of 31,3 million KM the share of domestic companies was up to 70%, which is disproportionate to their share in collected revenues amounting to about 30%. It can be concluded that the domestic industry has been to a greater extent affected by trends in the market of tobacco products in relation to importers. In addition to lower operating efficiency, which leaves little room for maneuver with retail prices, the reason is also the increased substitution of cigarettes with cut tobacco supported by the policy of companies which under the pressure of current trends for a time shifted the focus of business with cigarettes, which deliver greater added value and therefore revenue taxes, to the business with cut tobacco. In fact, comparing with 2012, from 53,2 million KM of additional revenues collected in 2015, only 2,1 million KM refers to domestic companies and the rest of it to importers.

Chart 10

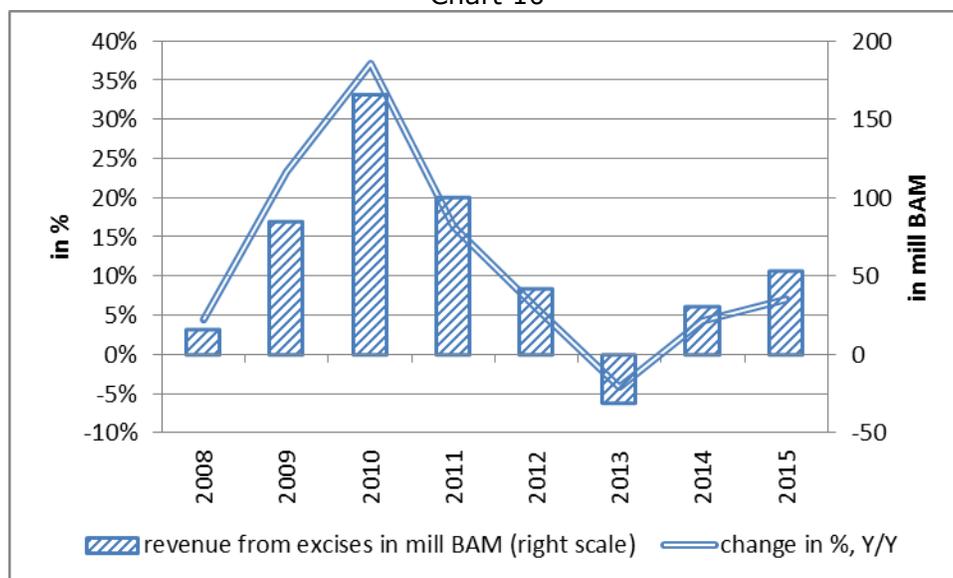
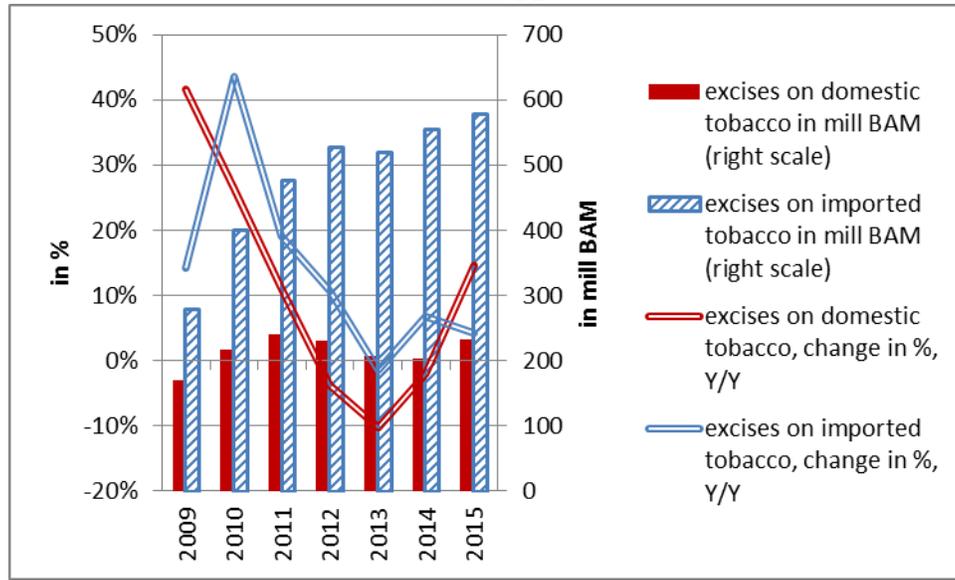


Chart 11



To analyze the effects of the measures of the new excise policy it is also important the analysis of the structure of excise revenues by type of tobacco products. Before escalating tax evasion, share of revenues from excise duties on cut tobacco was negligible and amounted to 3,9% in 2013. Measures of excise policy led to a decrease in revenues from excise duties on cut tobacco. In 2014, the share of these revenues in total excise duties has been reduced to 3,7% and in 2015 to only 0,9%.

## CONCLUSION

It can be concluded that the goal of the measures of the new excise policy was reached – substitution of cigarettes with fine cut tobacco is significantly reduced. Cigarette market has been stabilized, though it should be noted that tobacco companies, especially domestic ones, have lost more than half of the price before taxation. However, the current trend in revenues in 2016 shows that these effects have already been exhausted. Under the pressure of increase in excise duties on cigarettes in the coming years, in terms of the slow growth of the economy and aggregate consumption, the strengthening of the black market of cut tobacco and cigarettes is expected, with negative consequences for excise revenues, the profitability of the tobacco industry and stability of the market of tobacco products.