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European and Ukrainian Experience of Anti-Forestalling Regulations

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Abstract:

The article is devoted to analyzes the experience of European countries in the field of anti-forestalling regulation. It was found that anti-forestalling measures are divided into four types, such as: cap on tax stamps, cap on release for consumption, sell-by date, paying the tax difference. It has been found that in some countries of the EU optimal anti-forestalling regulation has been achieved over a period of time, in several stages and through the introduction of several measures at the same time. Determined that the rapid increase of excise tax rates on tobacco products in Ukraine also caused the problem of forestalling. Estimated that due to this the loss of tax revenues in 2015-2017 amounted to €2.9 to 4.5 million. It has been proved that current anti-forestalling regulation was not sufficiently effective for counteracting the accumulation of tobacco product stocks. In view of this, the article proposes a new anti-forestalling regulation in Ukraine, by improving the existing measure and introducing an additional term for the circulation of tobacco products in wholesale and retail trade with tax stamps purchased in the previous year to three months.

Keywords: anti-forestalling regulations, tobacco products, excise duties on tobacco, tax losses, tax gap

JEL Classification: E62; H25; H26; H39.

Introduction

Today, Ukraine faces serious challenges in the field of excise taxation of tobacco products, which is due both to the processes of adapting domestic legislation to the requirements of the EU common law (according to the Association Agreement) and to the increase of excise duty on tobacco products to overcome the imbalance of public finances, and to the need to improve the mechanism for administering the excise tax on these goods, which is the consequence of the application by individual market participants of a number of schemes for the reduction of tax payments (which in their essence is tax evasion and avoidance).

Given the above, the scientific substantiation of the directions of the transformation of the excise taxation of tobacco products in Ukraine in the context of the implementation of the Association Agreement with the EU, while taking into account the domestic features of the tobacco market and the need to improve the mechanisms for administering the excise tax on these goods, is particularly relevant. The practical implementation of the measures proposed in this article will make it possible to increase both the fiscal and the regulatory effectiveness of the excise taxation of tobacco products in Ukraine.

1. European Experience of Fiscal Forestalling Regulations

For a long time in the EU countries, along with harmonisation processes, a strategy has been implemented aimed at increasing the share of excise tax in the price of sales of a unit of tobacco products. Simultaneously with the restriction of the level of consumption of such goods, an increase in the level of excise tax makes it possible to achieve an increase in the level of tax revenue to the budget with minimal expenses for its administration. It should be noted that the consumption of cigarettes in the EU countries in recent years has decreased by 15% – from 553.4 billion in 2012 to 471.5 billion pcs in 2017.

Despite the effectiveness of the excise policy on reducing tobacco consumption, many EU countries, in addition to problems of smuggling and counterfeiting, faced the problem of optimising the payment of excise tax on tobacco products – forestalling (warehousing of tobacco product makers with excise stamps purchased before the raising of rates), which hinder the full realisation of the fiscal and regulatory potential of excise taxation. There is an increase in the volume of production of excisable products before increasing the excise tax rates in order to minimise the payment of tax liabilities in future periods. Consequences of such a negative phenomenon are the non-receipt of the excise tax to the budget, as well as distortion of competitive conditions on the market.

This problem is significant for most EU countries, which have introduced in response the most appropriate anti-forestalling measures depending on the specifics of the excise tax system and the control of the circulation of excisable goods in each country. Thus, according to the European Commission, about 70% of the Member States are applying anti-forestalling measures. Such measures are divided into four types¹:

1) *the establishment of quotas regarding the number of excise stamps issued*² (*cap on tax stamps*) (used in Bulgaria, Belgium, Denmark and Luxembourg). For example, in Denmark between November and December of the reporting year, this quota is 120% of the average monthly volume of excise stamps ordered in previous months. In the case of exceeding the quota, the excise tax is paid at rates that will apply from January of the following year;

2) *limitations on volumes of tobacco products that can be released for consumption (cap on release for consumption)* (used in Luxembourg, Portugal, the United Kingdom, Cyprus and Malta). For example, British companies have restrictions on the release of cigarettes for consumption from 1 January until the date of the announcement of changes in excise tax rates). In Portugal, there are restrictions on the number of cigarettes issued from 1 September to 31 December, calculated on the basis of 110% of the average monthly rate over the previous 12 months. In Malta, a similar measure is used, but without an adjustment coefficient for the possible positive market trends;

3) *establishment of a sale date (sell-by date)*:

3.1) *in wholesale trade (sell-by date at wholesale)* (used in Belgium, Hungary, the Netherlands);

3.2) *in wholesale and retail trade (sell-by date at retail)* (used in Estonia, Poland, Portugal, Slovakia). Such a measure provides for restrictions on the timing of the sale of tobacco products at certain tax rates. In Estonia, when a

¹ Some member states are mentioned twice, since the system applied can combine the standard methodology and additional measures in certain circumstances.

² The cost of the excise tax in most EU countries is included in the excise tax.

new excise tax rate is introduced, goods may be sold within three calendar months after the date of the new rate. Hungary has a similar policy where wholesalers must sell their products within 15 days of the announced date. In the Netherlands, manufacturers, wholesalers and importers can sell tobacco products with the "old" tax stamp within two months after the introduction of a new excise rate, but these measures do not apply to retailers. Finally, in Poland, the "old" tax stamps are valid only in the current calendar year and can be used until the last day of February of the following year;

4) *recalculation of tax obligations on excise tax on the date of actual sales of products to the consumer (paying the tax difference)* (used in Croatia, Denmark, France, Latvia, Lithuania, Slovenia). In Lithuania, this measure applies only to cigarettes still at wholesale traders, while in Latvia and Slovenia, the recalculation of tax liabilities is based on the inventory of tobacco product stocks at all levels of trade (European Commission, 2014).

In some European countries, such as Belgium, Luxembourg, Portugal, Denmark, several measures are used simultaneously to increase the effectiveness of anti-forestalling regulation. It is worth noting that some countries did not immediately identify the best anti-forestalling measures, but chose them on the basis of achieving the goal of equalising tax revenues throughout the year. Thus, in Poland, before the introduction of measures, the excise tax revenues were uneven throughout the year, their coefficient of variation was 71.1%. From March to May, revenues were significantly lower than in other tax periods, and from December to February – significantly higher (Table 1). In order to counteract this phenomenon, in 2009 a norm was introduced on the final date for the sale of tobacco products at all levels of trade, which was 6 months (end of June). Such measures did not have a proper impact on forestalling. Excise tax revenues were also unstable during 2009, but their variability decreased, while the coefficient of variation dropped to 66.4%. And already in January 2010, this deadline was reduced to 2 months (end of February). These measures proved to be effective, as a result of their introduction, the excise tax was equalised during the year, the coefficient of variation dropped to 14.9% in 2010 and to 12.1% in 2011, which is evidence of low variation in tax revenues.

Table 1. Influence of anti-forestalling measures on the uniformity of excise tax revenues from tobacco products in certain EU countries

Item no.	Country	Coefficient of variation, %		
		Before implementing the measure	After the first stage of anti-forestalling regulation	After the second stage of anti-forestalling regulation
1	Poland	71.1	66.4	14.9
2	Slovakia	178.4	32.4	21.2
3	Belgium	34.8	-	16.1

Source: Author's own calculations based on Tusveld et al., 2013.

The trends of the tax revenue of the excise tax on tobacco products in Slovakia, without the measures of anti-forestalling regulation of revenues, was similar to that observed in Poland, the coefficient of variation was 178.4%. Anti-forestalling measures were introduced on 1 February 2009, in the form of the establishment of a final date of implementation at all trade levels of 9 months (end of October), but revenue also had a high level of variability. Since February 2011, the date has been reduced to two months (coefficient of variation – 32.4%), and from February 2012 to one month (coefficient of variation – 21.2%). Consequently, only anti-forestalling measure of the last kind permitted to ensure the regularity and low variation of the tax revenue of the excise tax on tobacco products in Slovakia.

In Belgium in January 2012, several anti-forestalling measures in the form of quotas on excise stamps and final sales dates of up to 3 months after the increase of excise tax rates were applied at the same time, which enabled a reduction in the variability of tax revenue from 34.8 to 16.1%. The number of marks that could be obtained was calculated on the basis of the average monthly indicator of the past year increased by 15%.

It should be noted that according to expert opinions (Tusveld et al., 2013), of all the above anti-forestalling measures the most effective is a measure of type 3a, as its application:

- 1) complies with the EU Excise Duty Directives, does not depend on the taxation system and does not require the recalculation of obligations or use of the reference period, ensures the stability of tax revenues throughout the year;
- 2) does not depend on the system of labeling of tobacco products and does not involve additional expenses for tax administration and control over the circulation of excisable goods, does not distort market conditions.

2. Dynamics of Forestalling in Ukraine

A specific excise tax remains one of the most effective tools of tax regulation in Ukraine. The history of use of specific excise taxes in Ukraine dates back more than twenty five years, with some quite controversial periods of its application. However, today the most urgent issues include the determination of the optimal level of excise taxation and increasing the efficiency of its use both in limiting the consumption of goods that are harmful to human health and the impact on other qualitative and quantitative parameters of the market of excisable goods.

One of the main problems in the application of excise taxes throughout the period of modern history of Ukraine is the unsteadiness of tax legislation. Changes to the legislation regulating the application of a specific excise duty in Ukraine were aimed both at improving the mechanism of excise tax application and served exclusively for fiscal goals – due to tax revenues, it was possible to generate additional financial resources directed at financing certain public goods. As a result, both fiscal and economic efficiency of the tax also changed, and in some years there was a decrease in real (taking into account the component of inflation) tax revenue.

Implementation of the excise policy aimed at increasing rates, in recent years, has led to an increase in the fiscal efficiency of the excise tax. Thus, in 2009, the ratio of excise tax revenue to nominal GDP increased from 1.3% to 2.4%. The specified indicator in 2010-2014 remained at the level of 2.5-2.9%, but in 2017 its value increased to 3.9%. The increase of the fiscal value of the excise tax was the result of unsystematic increasing of its rates, as well as the introduction of a number of new tools in the domestic tax administration practice. We emphasise that, in Ukraine, the share of excise tax in GDP is quite comparable with the corresponding indicators in EU countries; however, another structure of excise tax revenue is specific for Ukraine.

In recent years, there has been a steady tendency for increase in the fiscal value of tobacco products excise tax, the share of which in 2017 was 32% of the total excise tax revenue and 54% of the excise tax revenue from domestic goods. Since 2009, tobacco excise taxes have comprised almost 57% of all revenues from excise taxes at average and approximately 41% of domestic products excise taxes.

It should be noted that such fiscal indicators are due to the specific demand and supply of tobacco products in Ukraine. Tobacco products belong to large taxpayers, and the average excise tax paid by them is 5.0% of the consolidated budget tax revenues. Thus, top 100 largest payers, in 2017 (Office of the State Fiscal Service), included 4 companies that produce tobacco products, including PrJSC AT TK V.A.T.-Pryluky, PrJSC Philip Morris Ukraine, PJSC JT International Ukraine, JSC Imperial Tobacco Production Ukraine.

Accordingly, the tobacco products market in Ukraine is highly concentrated and oligopolistic, the index of Herfindahl-Hirschman in 2015-2018 ranged from 0.23 to 0.26. As at the middle of 2018, there were 16 tobacco manufacturers registered, but the largest shares belong to PrJSC Philip Morris Ukraine (28.3%), PrJSC AT TK V.A.T.-Pryluky» (25.9%) and PJSC JT International Ukraine (25.3%). The license for retail trade was granted to more than 180 thousand retail outlets including specialised tobacco stores, supermarkets, hypermarkets, grocery stores, kiosks, snack bars, gas stations, hotels, restaurants and cafes, etc.

It should be noted that the dynamics of the tobacco market is significantly influenced by the excise policy, which until 2008 was quite liberal and led to an increase in the volume of tobacco products production. However, during the economic and financial crisis as a measure of "ambulance" of the budget, there was a significant increase in excise tax rates, which, in addition to unfavorable economic conditions, resulted in a decrease in official production of tobacco products to 94.0 billion pieces in 2012 and 86 billion pieces in 2014. In addition, this tendency can be explained by a reduction in the consumption of cigarettes on the background of a significant reduction in income levels among many social groups of Ukraine's population.

The Law of Ukraine dated 7 December 2017, No. 2245-VIII provides for an increase in excise tax rates for

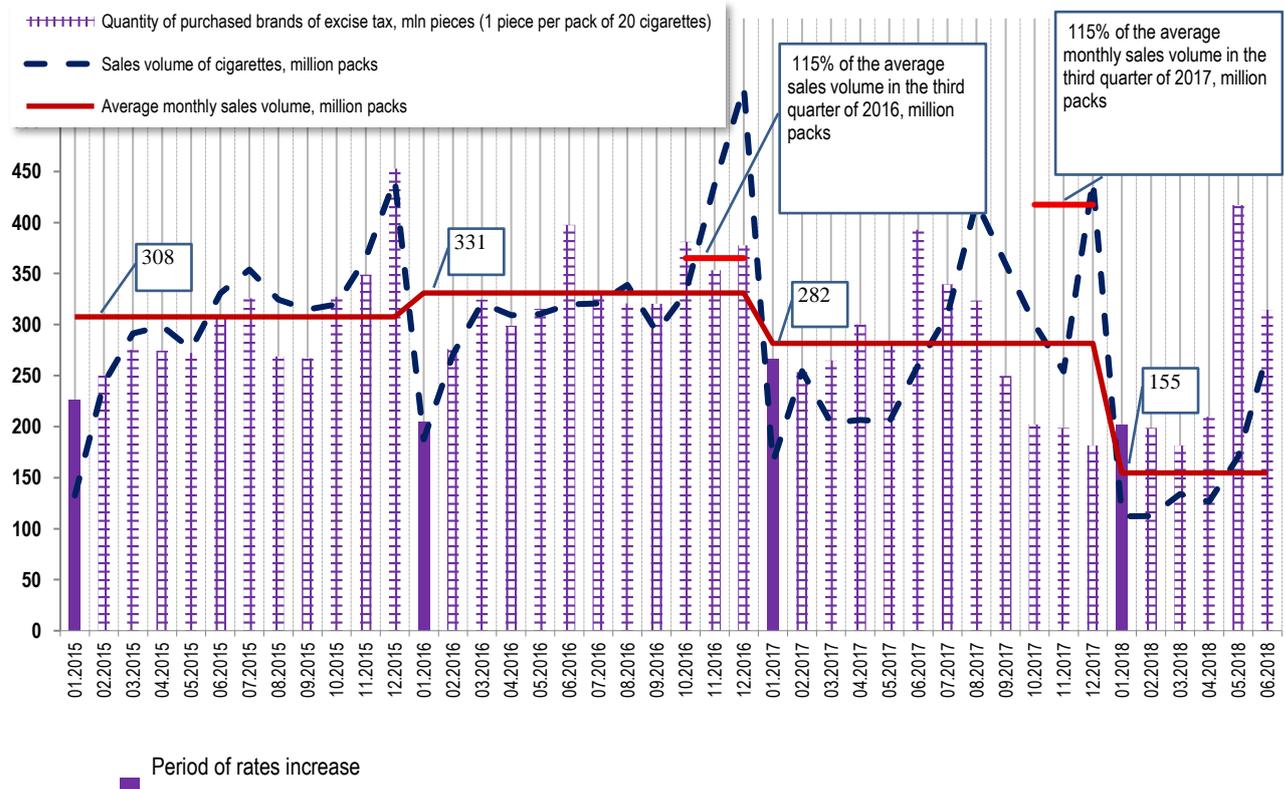
tobacco products in 2018, taking into account preliminary indexing by a total of 29.7%, and in the future by 2025 – by 20% annually until the EU minimum level is reached. This is an extremely important step towards solving one of the main problems of tobacco products excise taxation – the unpredictability of the excise tax rates increase.

Note that the increase in excise taxes for tobacco products in the countries that got EU membership was carried out within 12-15 years. In Ukraine, an accelerated timetable for raising excise tax rates for tobacco products may increase the illegal turnover of tobacco products. Taking into account the European experience and the current financial and economic situation in Ukraine, in order to achieve the appropriate level of excise tax, the transitional period should provide for more steady increase in rates and be sufficient to secure the rights of taxpayers, avoid negative economic phenomena and reduce budget revenue.

Despite the positive effect of the stability of the schedule for raising excise tax rates for tobacco products, the practice of reforming the excise taxation of the European Union states means that such measures may also have negative consequences for Ukrainian budget in the future, which should include forestalling.

Taking into account the fact that tobacco products are products with fast turnover and low price elasticity of demand, being almost independent from seasonality, the dynamics of the tax base should be similar to the dynamics of tax revenue, and any deviations from the average monthly indicators can indicate the optimisation measures for excise tax payment. In order to confirm or refute this hypothesis, it is expedient to analyse the monthly volume of acquired excise tax stamps in comparison with physical volumes of sales of tobacco products (Figure 1).

Figure 1. Trend of sales volumes of tobacco products and the number of purchased excise stamps 2015-2018



Source: Author's own calculations based on the State Fiscal Service of Ukraine data.

Analysing data for 2015-2018, one can see that January's revenue is significantly lower than the average monthly, which may indicate that at this time, manufacturers sell products that were taxed in previous year. From February to May, revenue trends coincide with sales volumes, and from June to August, tax revenue increases while sales volumes decrease. Starting in September, revenue exceeds the average monthly level, and with the decrease of sales volumes it increases, which indicates the beginning of accumulation of tobacco products before raising rates from 1 January.

The volume of acquiring excise tax stamps (Figure 1) since June is higher than the average monthly indicator (except for August and September), and from October to December the percentage of excess is 9.1, 16.3 and

51.0%, respectively, which confirms previous conclusions.

The situation with monthly revenue in 2016 and 2017 is similar to the situation in 2015: significantly lower in January than the average monthly value and much higher in the third and fourth quarters. In spite of this, the sales volume has a constantly growing trend, with a slight decrease in November. In the fourth quarter of 2016, the volume of the acquisition of stamps exceeded the average monthly volumes of sales of cigarettes in the third quarter by 11–20%.

In response to such challenges, since 2017, forestalling preventing measures have been introduced in the form of restrictions on the purchase of tax stamps in the fourth quarter. Namely, the volume of sales of excise stamps to the manufacturer or importer of tobacco products in a month should not exceed 115% of the average monthly sales volume in the customs territory of Ukraine for the three previous calendar months. According to European practice, such a measure can be attributed to the quota for the purchase of excise tax stamps (cap on tax stamps).

However, according to Figure 2, this provision did not ensure the achievement of anti-forestalling goals, since from August to December 2017, there were fundamentally opposite trends in sales volumes and tax revenue, indicating the beginning of accumulation of tobacco product stocks starting from not the fourth, but rather from the third quarter. So, in the third quarter the volume of acquiring excise stamps significantly exceeded the average monthly volume of sales of the first and second quarters, in particular, in July – by 57.4%, in August – by 49.9%, in September – by 15.7%.

Figure 2. The current anti-forestalling regulations in Ukraine



Source: Compiled by the authors on the basis of Tax Code of Ukraine.

3. Tax Gap of the Excise Tax on Tobacco Products from Forestalling in Ukraine

As noted above, taxpayers begin to accumulate cigarettes for the purpose of forestalling since the third quarter (i.e. within six months), in this regard, the loss of tax revenue from this phenomenon can be determined by comparing the sales volume in these quarters and the revenue of the average sales volume multiplied by 6 and multiplied by the difference between the minimum tax liability of the current excise tax and next year by the following formula:

$$Tax\ gap_f = (SV_{III\ IV} - ASV_{I\ II} \cdot 6) \cdot \Delta\ min\ ET$$

$$(\Delta\ min\ ET = min\ ET_{t+1} - min\ ET_t) \quad (1)$$

where $Tax\ gap_f$ – the amount of loss of tax revenue of excise duty tax on tobacco products as a result of the use of forestalling measures, thousand UAH;

$SV_{III\ IV}$ (*Sales Volume*) – the volume of sales of tobacco products in the III and IV quarters of the current year, thousand pieces.;

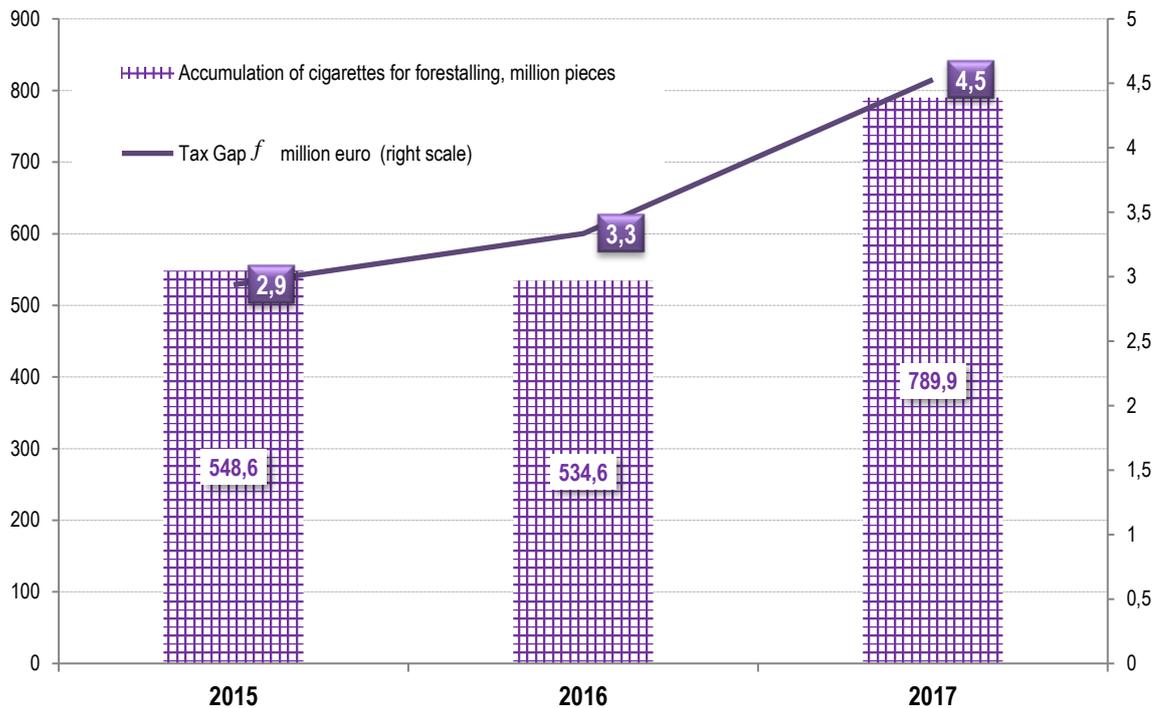
$ASV_{I\ II}$ (*Average Sales Volume*) – the average sales volume during the first and second quarters of the current year, thousand pieces;

$min\ ET_t, min\ ET_{t+1}$ (*Minimum Excise Tax*) – the minimum tax liability for excise tax in the current and next year, UAH per 1,000 pieces.

So, the current anti-forestalling mechanism did not achieve the goal of counteracting the accumulation of tobacco products before raising excise tax rates. However, according to the European anti-forestalling control experience, not all countries have introduced an effective system of measures on the first attempt. It is rather difficult to design a mechanism that would simultaneously provide stable tax revenue throughout the year and take into account changes in market conditions, while not disrupting the functioning of the tobacco market.

According to the calculations using the described methodology, the amount of tax revenue lost as a result of forestalling during 2015-2017 amounted to €2.9-4.5 million (Figure 3).

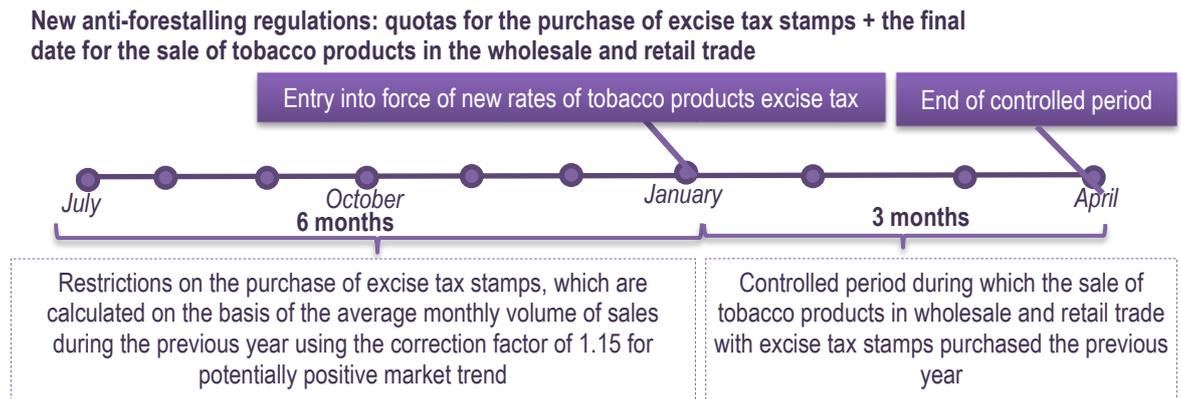
Figure 3. The dynamics of the tax breach from the excise tax on tobacco products as a result of the forestalling sale 2015–2017



Source: Author's own calculations based on the State Treasury Service of Ukraine and the State Statistics Service of Ukraine data.

On the basis of the analysis of the effectiveness of anti-forestalling regulation in Ukraine and the best European practices, we believe that it is necessary to change the domestic methodology for calculating quotas for the sale of excise tax stamps. They should be used in the third and fourth quarters and should be established by calculating the maximum possible monthly sales volume of excise stamps to the manufacturer or importer of tobacco products based on the average monthly sales volume of the previous year, and not on the basis of the three preceding calendar months of the current year (Fig. 4). Moreover, the correction coefficient for the possible growth of sales volume should be established on the basis of the trend in the tobacco market. Since the 2015-2017 period was characterised by a declining trend (the average annual rate of decline was 97.4%), we believe that this ratio should be set at 105%.

As an additional anti-forestalling measure, we propose to set the final date for the sale of tobacco products at wholesale and retail trade with excise tax stamps purchased the previous year (*sell-by date at retail*), which should be 3 months. Such a term is due to the need to create conditions for the free movement of goods at all levels of the supply chain. We believe that this will ensure an effective counteraction to the forestalling in the III and IV quarters, equalise the revenues of the excise tax on tobacco products during the year and will enable to receive the appropriate volumes of tax revenues at higher rates, will not have a significant effect on the market of tobacco products. At the same time, it is expedient to increase the deadlines for transferring the excise tax to the budget to reduce the distraction of working capital of taxpayers.

Figure 4. The Proposed Anti-forestalling Regulations in Ukraine

Source: Developed by authors.

Another possible anti-forestalling event may be the change in the mechanism of payment of excise tax on tobacco products to the one that provides the conversion to the budget of taxes payable by manufacturers and importers of tobacco products (excise tax payers) after the fact of selling products within the time set by the Tax Code of Ukraine for a monthly tax period. Such a mechanism would make the use of forestalling measures by the manufacturers unprofitable, and the budget will transfer taxes at the rate that is valid at the time of products sale.

Conclusions

In most EU countries, there was a need to apply anti-forestalling regulatory measures to equalise excise tax revenues during the year and to prevent accumulation of stocks with tobacco products containing excise stamps received before the rate increase. The main types of such measures are as follows: setting of quotas on the number of excise stamps released (cap on tax stamps); limitation of the volume of tobacco products which can be released for consumption (cap on release for consumption); setting of the sale date (sell-by date), recalculation of excise tax liabilities as of the date of actual sale of the product to the consumer (paying the tax difference). The analysis of practices in EU countries shows that the effectiveness of anti-forestalling regulation has often been achieved not on the first try, sometimes through introduction of several measures simultaneously.

Starting from 2015, the annual increase in the excise tax rate for cigarettes, occurring in Ukraine on 1 January has led to the use of forestalling activities by tobacco companies. Losses of tax revenues from these actions in 2015-2017 amounted to €2.9 to 4.5 million. The analysis of effectiveness of the anti-forestalling regulation shows that solution to the tobacco stockpiling problem failed. Excise taxpayers have transferred the use of forestalling from the fourth quarter of the year to the third quarter. In view of this, it is necessary to restrict the sale of excise duty stamps starting from the third quarter of the reported year, and their maximum purchase volume should be calculated on the basis of the average monthly sales volume of tobacco products of the previous year adjusted for the growth rates of the tobacco market of the previous periods. Moreover, in wholesale and retail trade it is expedient to limit the period of circulation of tobacco products with excise tax stamps, purchased in the previous year, up to three months.

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