

**PROPOSAL ON EXCISE TAXATION**  
**FOR IMPORTED CIGARETTES**  
**INTO UZBEKISTAN**

**BACKGROUND**

The Uzbekistan cigarette market is presently estimated at 14-16 billion cigarettes per annum. Of this only 3 billion is expected to be fulfilled from domestic manufacture in 1995 although this is planned to increase to 8.9 billion in 1997 with further increases thereafter as new local production facilities (new Samarkand factory of UzBAT joint venture) becomes fully operational. The bulk of the present market is therefore satisfied through imports. These imports are largely very cheap, often poor quality products.

An excise tax is payable on imported cigarettes but revenue receipts and market prices suggest that many, if not the majority, are escaping taxation and the Government is therefore losing significant revenue. Policing of products in the market by the authorities is difficult as there is presently no way of differentiating between taxed and non taxed products. This could also apply to excisable products other than cigarettes. The estimate of total excise and VAT that should be payable at present tax rates on the cigarette market in Uzbekistan, for both domestic production and imports, is Soms 2 billion per year. This estimate reflects the high percentage of low value cigarettes in the Uzbekistan market.

To attempt extracting significantly higher revenues too fast will only cause the cigarette market to shrink due to the limited purchasing power of the consumer. Excessive taxation only encourages evasion which can never be eliminated completely. A shrinking market would only negate Government actions to increase revenue. The first priority must, therefore, be to concentrate on a system that will enable the highest success in collecting taxes and limits the extent of untaxed products in the market. With just one domestic manufacturer in Uzbekistan the emphasis of the system must be directed at controlling imports.

**EXISTING AND PROPOSED SYSTEM**

**Existing system**

Under the present system the local manufacturer and importers use what is known as an administrative system. Under this system tobacco products may only be manufactured in premises approved by the tax authority and the excise tax becomes payable when products are sold and leave the premises. Tax on imports is payable on import and before the goods are released from Customs control. The tax authorities control the system by reconciling the records and accounts of inputs and outputs and carrying out audits. Once the goods enter the market there is no way of distinguishing between fully taxed and untaxed, illegal, products. This makes policing impossible and

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consequently allows for a high level of untaxed products in the Uzbekistan market.

#### **Outline of proposed system**

The system recommended is a tax stamp or tax marker which is applied to all properly taxed products at the time of manufacture. The principal advantage of this system is that it provides easy identification of illegal untaxed products in the market. The system is used widely throughout the world and has proved very effective in aiding the collection of taxes. The system does, however, require adequate policing to be effective. This involves controls over printing and issuing of stamps, the audit of registered importers and active monitoring in the market for unstamped products. Recommendations on policing and controls could be the subject of a separate paper.

#### **Production and sale of stamps**

The printing and sale of tax stamps is the responsibility of the tax authority. They must be printed to a high quality to deter forgery and be sold only to authorised manufacturers and importers. Details of tax stamp design can be recommended. It is fundamental to the effectiveness of this system that the tax authority is able to supply the quantity and variety of tax stamps applied for quickly and accurately. Delays or mistakes in supplying stamps will disrupt production and importation. The tax authority may find it expedient to have stamp stores on the premises of large users. Importers and manufacturers should have the ability to return damaged stamps or stamps on returned goods for tax reimbursement. In some instances the stamps will have to be destroyed under official supervision.

With additional equipment the bank note printer in Tashkent could produce these stamps. An alternative and perhaps a quicker method to implement both the printing and control systems for stamps would be the employment of a specialist foreign company to produce and manage the issue of stamps, at least for an initial period.

#### **Manufacturers and importers responsibilities**

Manufacturers must securely affix appropriate tax stamps to each pack during the manufacturing process. Importers will need to make arrangements for this to be done by overseas manufacturers. It will be an offence to be in possession of unstamped packets of cigarettes ~~and~~ <sup>which</sup> will be liable to forfeiture.

Manufacturers and importers must keep records which can be audited by the tax authority to satisfy itself that the number of products being manufactured or imported can be reconciled with stamp purchases.

#### **Advantages**

The system has the following advantages:

- The tax stamp can conveniently include tobacco excise tax and import duties

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- The tax is paid by a comparatively small number of authorised manufacturers and importers who will keep auditable records and accounts.
- Sales of untaxed, unstamped cigarettes on any significant scale are extremely difficult.
- It provides for easy control of tax refunds on unused stamps or stamps on full damaged packets.
- Stamp issues can be identified to individual manufacturers and importers and reconciled with their production or import record.
- Large users can have official stores of stamp stocks on site.

#### **Disadvantages**

The system has the following disadvantages:

- The tax authority may have to produce a range of stamps and be able to change them quickly when any factor changes.
- It is critically important to manufacturers and importers that the right stamps are available at the right time.
- The Government revenue is net of the cost of producing and distributing the stamps although the costs are vastly outweighed by the improved revenue collection.
- Affixing the stamps is an additional manufacturing or importing procedure and an additional cost.
- Arrangements may have to be made to supply overseas manufacturers with stamps although the establishment of local authorised agents should help this.
- Refunds have to be paid upon stamps which are either damaged or unused.

The effectiveness of the system depends on the efficiency and responsiveness of the arrangements for printing and distributing the stamps.

#### **Tax stamp legislation**

The legislation would normally include some or all of the following:

- All cigarettes which are offered for sale should have a tax stamp affixed to the unit of sale (the packet). It is therefore becomes illegal to sell cigarettes without them.

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- The method and timing for the ordering of tax stamps by the importers and manufacturers, the official form to be used and the arrangements for their delivery.
- The appointment of printers who will produce the stamps and confirmation that this cost is paid for by the Government.
- The size of the cigarette packets allowed in terms of the number of cigarettes per packet. At present in Uzbekistan this is 20 cigarettes per packet. To limit the smuggling of unpacked cigarettes it may be necessary to make the sale of individual cigarettes by retailers illegal.
- The location of the stamp on the packet and that it must be affixed directly to the packet and not the transparent wrapping during cigarette packing.
- Information to be included on the stamp.
- Cigarettes must be manufactured or imported only by traders authorised by the tax authority.
- The procedure for reimbursing the manufacturer for tax stamps not used, or damaged, during the manufacturing process. Normally, this requires them to be returned to the Government as proof of non use or damage, after which a refund is made.
- The records that manufacturers and importers must keep of tax stamp purchases, stocks, utilisation, plus production, import and sale of cigarettes.
- The administrative arrangements for supplying tax stamps to overseas manufacturers and importers.

#### PROPOSED CALCULATION AND RATES

Tax rates vary widely throughout the world but there are only two basic methods of applying them to cigarettes: a **specific system** levied upon the cigarette itself by number or weight of cigarettes sold or an **ad-valorem system**, where the tax is calculated as a percentage of price. Some Governments apply a combination of these two methods to give a mixed specific/ad-valorem system.

The principle disadvantage of the specific system is that revenue yield will not increase in line with price increases; the tax rate has to be increased when necessary leading to a higher administrative burden. The main advantage of the ad-valorem system is that it is geared to inflation. As prices increase so does the revenue yield. An additional advantage of the ad-

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valorem system is that higher taxes are received on the higher priced cigarettes, particularly the high priced international brands.

The present excise calculation in Uzbekistan is ad-valorem and given the nature of the Uzbek cigarette market of wide ranging prices and with high inflation, this same method is recommended to continue.

One amendment to the present calculation strongly recommended for imported cigarettes is to set a minimum tax level. As already mentioned, a particular characteristic of the Uzbek market is the high percentage of very low priced, often poor quality imported cigarettes. One problem likely to occur with the imposition of excise and duties on imported products, and not just cigarettes, is the use of under declaring of prices in invoices to reduce import taxes. Another threat is the use of dumping excess or very low quality production from other countries into Uzbekistan. By setting a minimum tax on imports the Government can be sure of always receiving at least a minimum rate of tax on all products. To ensure devaluation is always taken into account to maximise revenue the minimum should be calculated against a Dollar value.

It is normal practise throughout the world, with Russia a new and notable example, to ensure some degree of protection is given to domestic manufacturers and not just for cigarettes. The setting of a minimum tax level not only ensures acceptable revenues are always received but does also provide some degree of protection to domestic manufacturers from underpricing and dumping. A further encouragement to all local industries would come from the introduction of import duties.

In summary, the rates recommended would be as follows:

	Domestic Manufacture	Imported Products	
Filter cigarettes	40% (As present)	40% (As present)	
Plain cigarettes	25% (As present)	25% (As present)	
Minimum tax - filter		\$3,50 per 1000	cif
- plain		\$1,00 per 1000	<u>B/level</u>
			5.20
			3.00

In addition an import duty of between 15% and 25% on import cost is recommended as a level that would maximise revenues without adversely affecting the size of the market.

The effect on Government revenue of these rates is discussed below. In making these recommendations the impact on cigarette retail selling prices was examined. The enforcement of taxes on the market will inevitably lead to higher prices as importers try to cover their increased costs. It is important that such price increases are not excessive as this would cause the market to shrink as consumers become less able to afford imports. This is particularly

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so for the next two years until the domestic manufacturer can replace imports. A balance must therefore be met which maximises revenue to Government without harming the market. ✓

### IMPACT ON MARKET AND EXISTING TRADERS

The enforcement of existing rates with minimum tax levels as indicated above would have the following expected impact on market prices:

	<u>Market Prices Per Pack Of 20 Cigarettes in Som</u>			
	<u>Before Present Import Excise</u>		<u>Expected After New System</u>	
	Local	Imported	Local	Imported
Plain brands	2.5	2.50	3.00	4.5
Filter brands -low price	n/a	5-6	n/a	8.50
- medium	n/a	12.00	n/a	15.00
-high price	n/a	22-24	n/a	32.00

? *apparent comparative*  
The above ~~apparent~~ price increases are due to present market prices not fully reflecting existing taxes. The ability of importers to increase prices will be limited, however, by competition from locally produced cigarettes. ✓

?  
The minimum tax recommended was calculated to equal the ad-valorem tax payable on the present lowest price cigarettes. In this way Government can be sure to collect the full tax even if import prices are under declared or products dumped into the Uzbekistan market at unrealistic prices.

X  
For the proposed system to be effective it is fundamental that control is exercised over importers. It is normal practise in all countries with good excise control to require that importers are licensed to trade in excisable products. This means tax stamps can only be issued to legal importers subject to audit by the tax authorities. At present many importers are small traders who will be unable to import the larger quantities required by overseas manufacturers to pack cigarettes with the Uzbekistan stamp. Only the largest importers will be able to continue with the smaller traders buying from the importers. The present system of individuals being allowed to bring into Uzbekistan sizeable person allowances of cigarettes should be stopped as this is one of the main routes for evading the system. Adequate notice of any new law introducing this system must therefore be given to allow importers and small traders to prepare. If not, a drastic shortage in the market could occur that would not be filled at present by the domestic manufacturer alone.

### IMPACT ON GOVERNMENT REVENUE

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Calculations have been made to determine the impact on revenues under different assumptions. ~~Further calculations can be made as required and are important to ensure expected results are reasonable.~~

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	Soms billions	
1. Annual income, including VAT, with present rates. Much of this may presently be evaded	2.0	\$60 million
2. As per 1 but with the minimum tax levels recommended above (The increase in revenue is small as the minimum tax levels have been purposely calculated to provide only a base to existing rates and not as additional taxes. Increases in the minimum rates would make the lower priced brands uncompetitive resulting in a smaller market)	2.1	
3. With reduced ad-valorem rates of 33% (filters) and 20% (plain) but with increased minimum rates of \$4.0 for filter and \$1.50 for plain. This to show the sensitivity between the ad-valorem rates and minimum rates while maintaining price levels and revenue.	2.0	
4. As per 2 but with an import duty of 20% on imported cost. While import duties are a separate issue to excise the Uzbek market is presently a predominantly import market and will be sensitive to duties. This is included to give a sensitivity on revenues at a duty rate that would not overprice the market.	2.7	

The primary objective must be to introduce a system that will ensure maximum collection from the tax rates as set together with the necessary policing. With this system functioning and the market adjusted further changes could be made with more confidence.

#### PROPOSED PAYMENT CONDITIONS

Tax stamps can represent a fixed level of tax according to rates at the time of issue. The stamps are effectively purchased like postage stamps. The disadvantage of this is that by the time the cigarettes reach the market with the stamps applied, possibly months later, cigarette prices could have increased and Government would lose the revenue on the higher prices. This is not therefore recommended for Uzbekistan.

Some countries use the tax stamp purely to show the cigarettes have come from an authorised importer or manufacturer. In this instance the tax stamp does not represent a fixed amount of tax which is then calculated under the administrative system of monthly calculation and reconciliation. This method can delay the receipt of revenues to Government.

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A mix of both is therefore recommended. An amount of tax becomes payable with the application to purchase the stamps and the balance is paid according to prices at the time of importing the cigarettes. In this way Government receives some revenue earlier, the importer is encouraged to use the stamps as quickly as possible and the final tax payable is calculated upon latest prices.

An amount equivalent to approximately one third of the full tax is recommended as a prepayment after a suitable period of credit to allow for production, delivery and stock holding by importers. ~~(Belgium for example allows 60 days after stamps are issued.)~~

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### POSITION OF DOMESTIC MANUFACTURER

Uzbekistan is in an easier position compared to many countries in that it only has one domestic manufacturer to control and with few brands for the time being. As excise tax on locally produced cigarettes would be unchanged it is arguable whether tax stamps are needed at all for the domestic manufacturer.

In the longer term when production of international brands commences locally it would not be desirable for such brands to be differentiated from the same brands produced overseas. However, in the short term the domestic manufacturer has only just started to refurbish it's Tashkent factory. The application of tax stamps to packets requires the necessary equipment which is being planned, although details of the stamp and how it is attached (on side, front or top) will be required. A period of 12 to 18 months would therefore be required before stamps could be applied to locally produced cigarettes.

The problem is simply to ensure all imports are paying full taxes. With the level of revenue possibly being lost it is understandable for the Government to want to introduce a system as soon as possible. Most foreign manufacturers already have the means to apply stamps as this is such a common practise world-wide. A tax stamp system for imported products could therefore be implemented just as soon as the logistics of producing and controlling the stamps together with appropriate policing methods are put into place.

### SUMMARY

The Uzbekistan Government is ~~believed to be~~ losing significant revenue from the non payment of taxes on imported cigarettes. This is impossible to fully police as there is presently no method for identifying illegal products in the market.

The system recommended is a tax stamp that importers must purchase from Government and send to foreign manufacturers for attachment to cigarette

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packets. This system is widespread throughout the world and has proven very effective.

~~The excise calculation to be applied to importers should be based on import cost as at present. This ensures revenues increase in line with inflation and higher revenues are collected from higher priced brands. However, to ensure Government revenue is protected against under priced imports or dumping by foreign companies a minimum tax is also recommended. This minimum would be designated in Dollars to again ensure revenues at least increase in line with devaluation.~~

If these fundamentals are accepted further recommendations can be given relating to stamp design, stamp printing, stamp controls, policing and other logistics as required.

<sup>excise</sup>  
The (tax and VAT rates to be applied to imported cigarettes should be the same as for the domestic production. The base for the calculation should be the c.i.f. price (plus import duty when introduced)

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