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Tobacco products in Ukraine: Market state and taxation

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The Vienna Institute for International Economic Studies
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Abstract

The Ukrainian tobacco market has several characteristics that differentiate it from its peers in the EU. Today, this market faces some complex issues. There is a strong public demand to fund military needs, in light of which tackling the illicit market to raise tax revenues and increasing excise duties are being discussed. Also, Ukraine is currently undergoing its EU integration process, which requires the country to increase its excise duties on tobacco products to the EU's minimum level. Moreover, the largest share of daily smokers is in the 18-29 age group, which indicates an adverse trend of growing prevalence of smoking among the young. Heated tobacco products (HTPs) are popular among Ukrainians. The tobacco industry lobbies for a 20% tax advantage on HTPs, compared with cigarettes; this results in lower tax revenues despite a lack of public health evidence. This landscape study seeks to analyse the current situation in the industry and provide policy recommendations to tackle today's challenges.

Keywords: Excise, Tobacco, Smoking, Tobacco consumption, Tax advantage

JEL classification: H20, I18, L66

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1. Executive Summary

The Ukrainian tobacco market has several aspects that differentiate it from its peers in the European Union (EU) and other comparable markets. While 23% of the adult population consumes tobacco and nicotine products daily, another 4% does so less regularly. The share of daily consumers is the highest in the youngest age group (aged 18-29) and decreases with age, which may support the hypothesis that the trend of smoking prevalence is reversing upwards.

Cigarettes remain the most popular product among all age groups except the 18-29 group, in which cigarettes, heated tobacco products (HTPs) and electronic cigarettes all have similar shares (43-44%). Young people tend to start their consumption with new tobacco and nicotine products and to consume multiple products. The positive correlation between a person's income level and the level of tobacco product consumption indicates that pricing affects consumption.

The role of the tobacco excise revenue has increased in recent years, among other factors due to increased excises. In December 2017, Ukraine approved a seven-year plan to increase the excise tax on tobacco products by 20% annually (VRU 2018). This measure was supposed to ensure convergence with the EU's Tobacco Taxation Directive (EC Directive 2011/64/EU) on the minimum excise tax liability of at least EUR 90 per 1,000 units by 2025.

Since this schedule did not allow the EU-set minimum level of taxation to be achieved by 2025 – due to higher devaluation of the Ukrainian hryvna (UAH) triggered by Russia's full-scale invasion of Ukraine – it became necessary to revise the excise tax rates in order to gradually reach this level by 2028. As a result, in June 2024, the Parliament of Ukraine approved a new tobacco excise draft law (VRR 2024) in the first reading, and the law was fully adopted in December of that year. The law will denominate excise rates in euros with a front-loaded increase schedule. In addition, since September 2024, Ukraine has had an excise for oral nicotine pouches, becoming only the 10th country with such an excise among EU members states and candidates. On the downside, however, lawmakers have decoupled excise growth for HTPs from cigarettes, setting the target excise for 2028 at a level 20% lower than that set for cigarettes.

The analysis of the fiscal impact of increasing tobacco excise taxes, based on the tax model developed by Fidanovski et al. (2024), shows that the inflation-adjusted excise revenues from cigarettes will increase from UAH 73 billion in 2024 to UAH 97 billion in 2028, while industry profits are expected to remain mostly unchanged, returning to moderate growth in 2028. Decoupling the excise is likely to cause a partial shift in consumer behaviour away from traditional cigarettes. The initial HTP quantity drops from 6,855 million sticks in 2023 to 5,424 million sticks by 2028, but consumption of HTPs is projected to grow after 2026. Given that such a policy approach will also lead to significant budget losses over the four-year period (on top of its impact on health), one of the key policy challenges for the coming years will be to increase the excise for HTPs.

Collectively, the five largest producers of tobacco products in Ukraine pay 99.7% of domestic excise revenues. Among them, there are four multinational companies – British American Tobacco (BAT),

Japan Tobacco International (JTI), Philip Morris International (PMI) and Imperial Tobacco – and one larger local plant. For the last 12 months ending in October 2024, the monthly sales averaged UAH 9.7 billion, or UAH 116.6 billion annualised.

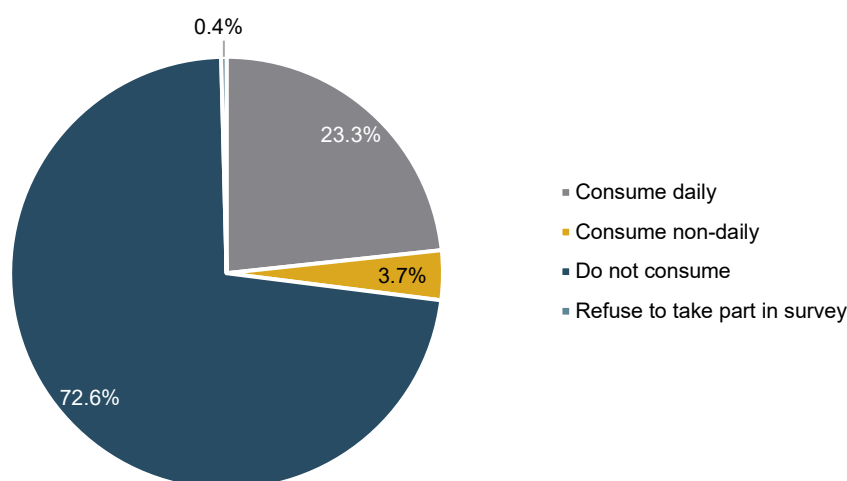
Despite the strong public demand to finance military needs, Ukrainians also expect to avoid rising taxes on consumption and have asked for this to be achieved by fighting illicit sales and closing loopholes in the tobacco industry. Nevertheless, tobacco excise increases are well accepted.

There is still a significant issue with illicit sales, with estimates of the illicit market's share ranging between 10% and 20%. The distribution of illicit tobacco products is conducted mostly through kiosks, street vendors and online sales, especially via groups in Telegram Messenger. Tackling the illicit trade is one of the prerequisites for decreasing the accessibility of tobacco products, especially for youth. This will also make the fiscal measure more effective by decreasing consumption and increasing budget revenues.

2. Consumption of tobacco products by Ukrainian households, quantity and value

In October 2024, the Kyiv International Institute of Sociology (KIIS) conducted a survey on the 'consumption of tobacco and nicotine products and attitudes towards tobacco control measures' (KIIS 2024), which used computer-assisted telephone interviews (CATIs). The respondents were only people over 18 and only those who resided in the government-controlled territory of Ukraine at the time of the survey. A total of 2,019 interviews were conducted as part of the study. Respondents from 24 regions of Ukraine and the city of Kyiv took part in the survey. Among respondents, 27% currently use tobacco or nicotine products (23.3% daily, and the remaining 3.7% from time to time).¹

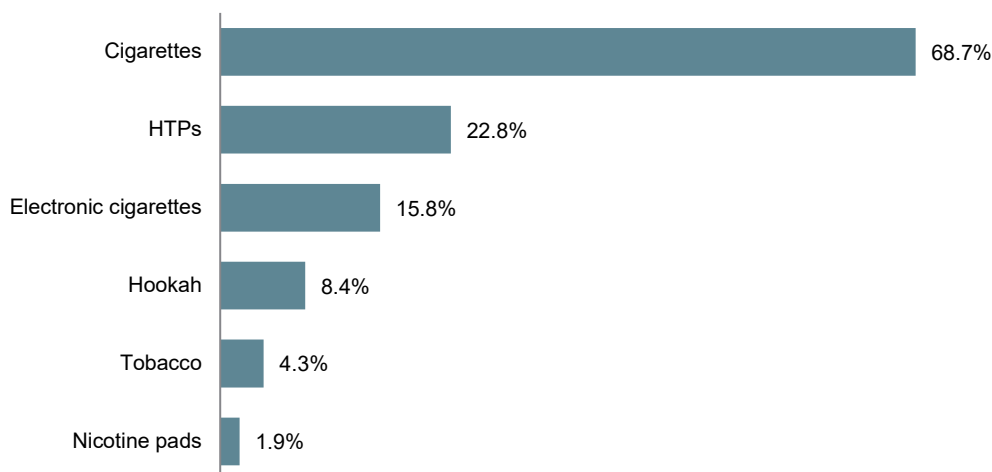
Figure 1 / Consumption of tobacco and nicotine products in Ukraine in October 2024



Sources: KIIS (2024)

Among the 27% of respondents who consume tobacco or nicotine products daily or only occasionally, the most popular type of product is a cigarette (68.7%). The second most popular products were HTPs (22.8%), followed by e-cigarettes (15.8%).

¹ In a survey of Ukrainians published on 31 May 2023 (WHO 2023a), the World Health Organization found that approximately 27.4% of respondents were current users of tobacco and nicotine products (23% of the respondents were daily users). The surveys of both the WHO and KIIS included HTPs and e-cigarettes in their models.

Figure 2 / The most commonly used tobacco or nicotine products in Ukraine

Source: KIIS (2024)

The majority (68.7%) of tobacco and nicotine product consumers smoke cigarettes, although the rate has decreased since 2023, when the figure was 74.7%. Considering that the HTP consumption rate increased compared to 2023, it can be assumed that smokers of cigarettes and tobacco shifted to HTPs. However, such an assumption requires further research. In addition, there is a positive correlation between a smoker's age and their consumption of cigarettes. In other words, older smokers are more likely to consume cigarettes over other tobacco products. Also, the level of cigarette consumption is lower in big cities compared to small towns or villages. While 79% of smokers in these places consume cigarettes, the equivalent rate in cities with more than 100,000 residents is 58.9%. Moreover, there is an inverse relation between consumer affluence and cigarette consumption. While 81% of smokers with low levels of income consume cigarettes, the rate for wealthy consumers is 55.2%. This data suggests that cigarettes are considered inferior goods nowadays.

When looking at distribution of consumption by product types across age groups, the share of the age group that consumes cigarettes increases with age. Cigarettes remain the most popular product among all age groups except 18- to 29-year-olds, whereas cigarettes, HTPs and e-cigarettes all have similar shares (43-44%) given the simultaneous consumption of multiple product types. The notable inverse correlation between age and share of the age group that consumes HTPs and e-cigarettes may indicate an even higher share of consumption of these products in the subset of underage smokers.

In Ukraine, the use of tobacco and nicotine products is more prevalent among males (39.5%) than females (16.7%), but the use of HTPs and e-cigarettes is more prevalent among females. In fact, the respective rates of consumption are 34.2% and 20.4% for females, which is almost twice as higher as the rates for male smokers (17.0% and 13.4%, respectively).

Furthermore, there is a positive correlation between a person's income level and the level of tobacco product consumption. While 27.4% of people on the low-income level consume tobacco products, the figure is 33% for smokers with higher income levels.²

For HTPs, the share of consumption also grows with an increase in income. While only 8.6% of smokers with low-income levels use HTPs, the table is 33.3% for high-income smokers. Moreover, HTPs and e-cigarettes are more prevalent in big cities than in villages or small towns.

Cigarettes have the highest share in consumption of the members of low-income (but not very low-income) families, while the overall prevalence of tobacco and nicotine products is highest among high-income consumers.

Table 1 / Consumption of tobacco or nicotine products in Ukraine by socio-demographic categories (in %)

	Current consumption			▶		Types of products consumed			
	In total	Daily	Not daily	▶	Cigarettes	HTPs	E-cigarettes	Hookah	Tobacco
Gender									
Male	39.5	34.9	4.6	▶	72.9	17.0	13.4	9.1	6.1
Female	16.7	13.7	3.0	▶	60.5	34.2	20.4	7.1	0.7
Age									
18-29 years	32.9	27.4	5.5	▶	43.7	44.6	44.2	21.2	0.6
30-39 years	32.5	27.1	5.4	▶	59.6	34.6	21.7	12.3	0.7
40-49 years	29.5	25.3	4.2	▶	76.1	14.4	6.0	4.7	8.1
50-59 years	30.7	27.7	3.0	▶	84.3	9.5	3.2	1.7	3.3
60-69 years	20.5	18.6	1.9	▶	82.9	5.7	0.0	0.0	11.4
70+ years	11.1	9.9	1.2	▶	87.2	4.7	0.0	0.0	8.1
Region									
West	21.5	17.1	4.4	▶	70.4	14.3	15.1	10.4	1.7
Centre	26.6	23.2	3.4	▶	72.7	22.1	15.1	8.7	2.5
South	32.0	28.1	3.9	▶	62.9	29.7	20.8	8.7	4.0
East	32.3	30.4	1.9	▶	66.8	24.8	6.1	2.6	16.4
Type of settlement									
Village	22.7	19.0	3.7	▶	79.0	10.5	15.2	5.4	4.5
Urban-type settlement (under 20,000)	24.6	21.2	3.4	▶	83.7	14.9	7.4	12.3	1.4
City (20,000-99,000)	27.6	26.2	1.4	▶	72.9	20.8	14.4	9.9	6.2
City (100,000+)	30.6	26.2	4.4	▶	58.9	31.6	18.0	8.9	4.3
Level of family's income									
Very low	27.4	22.7	4.7	▶	61.7	8.6	8.5	0.0	17.6
Low	24.0	20.3	3.7	▶	81.0	15.0	9.3	3.0	5.6
Middle	26.4	24.0	2.4	▶	68.8	25.4	15.2	9.3	1.5
Hiah	33.0	26.8	6.2	▶	55.2	33.3	26.9	16.5	2.3

Sources: KIIS (2024)

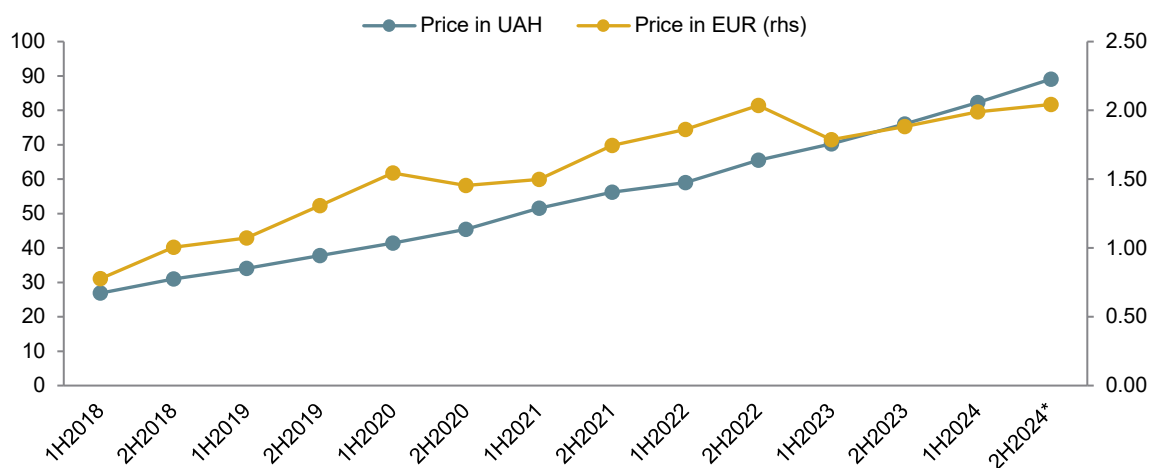
² A 'very low' level of income means that a household member replied that they do not have enough money even for food; a 'low' level indicates that the household has enough money for food, but not enough for clothing; a 'medium' level indicates those that have enough money for both food and clothing, but not enough to buy some expensive products (e.g. a TV); and a 'high level' indicates those that can afford some expensive things or can afford everything in general.

3. Pricing

As of May 2024, the price of a 20-cigarette pack of medium-class filtered cigarettes averaged UAH 87.14 (approx. EUR 2.00), which represents an increase of 231% in nominal terms (or 155% in real terms) since January 2018. This price includes UAH 50.34 of excise tax and UAH 14.53 of value-added tax (VAT), making total indirect taxes amount to 74.4% of the retail price.

Due to the adopted excise increase plan and inflation, the average price of a pack of cigarettes steadily increased (in nominal terms) over the last six years. However, when denominated in euros, the price stopped increasing at just above EUR 2.00 due to the devaluation of the Ukrainian hryvnia after Russia's full-scale invasion of the country.

Figure 3 / Price of 20-cigarette pack of medium-class cigarettes



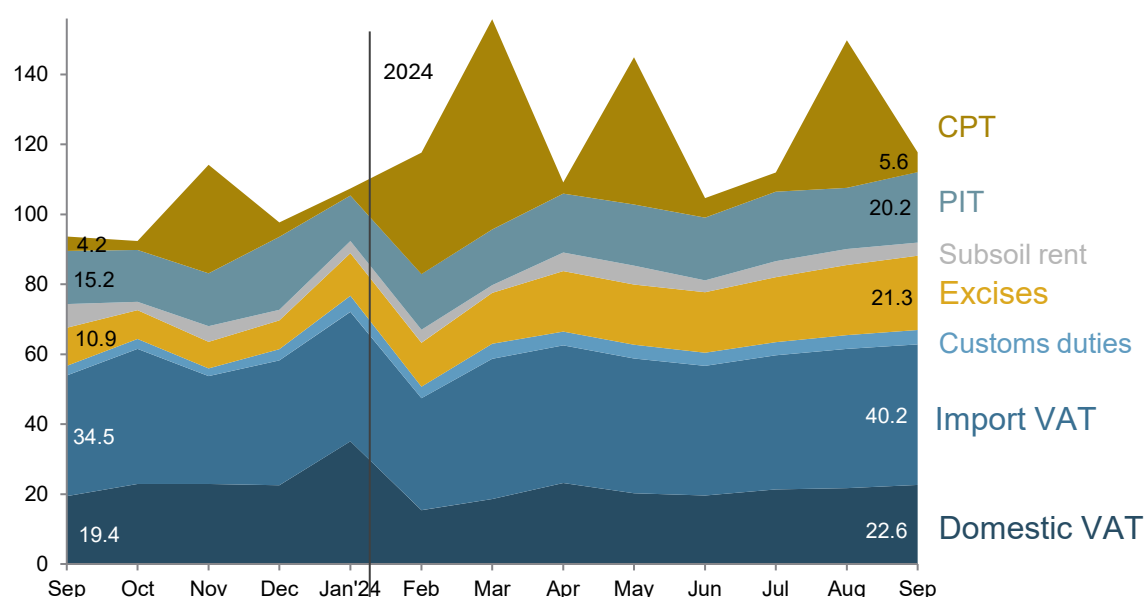
Sources: authors' calculations

4. Sales and tax revenues

Overall tax revenues of the state budget are steadily growing, increasing by 26% year on year in September 2024, while the accumulated consumer price index (CPI) for this period reached 8.6% and the base inflation 7.3%.

Of the UAH 117.9 billion in September revenues, UAH 21.3 billion were excises revenues, representing a year-on-year increase of 95%. Of these UAH 21.3 billion, UAH 10 billion (approx. EUR 225 million) were tobacco excises.

Figure 4 / Monthly state budget tax revenues, UAH bn and %



Source: Ministry of Finance of Ukraine; authors' calculations

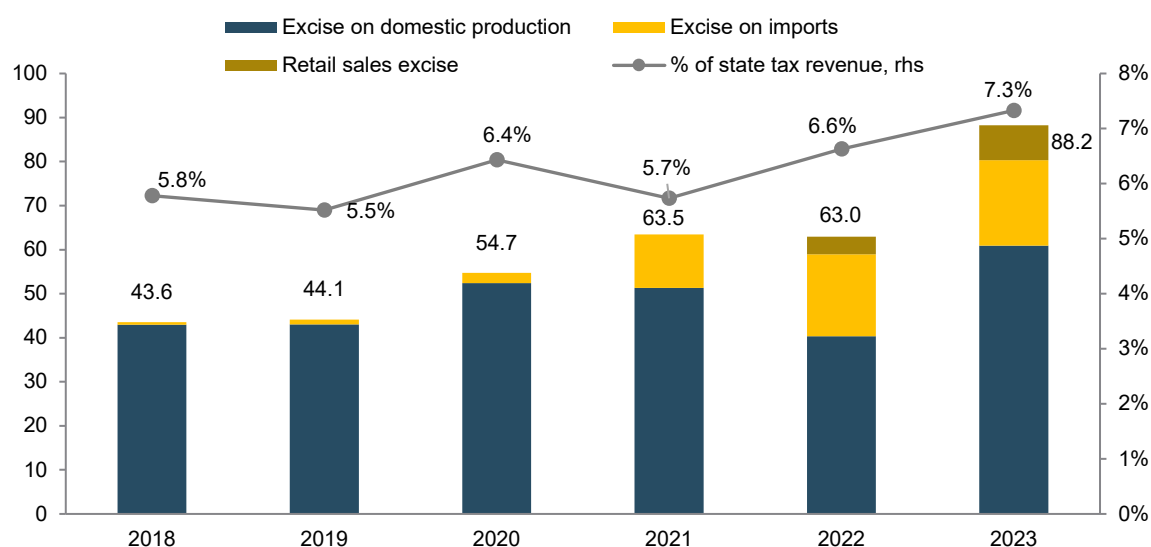
Notes: CPT = corporate profit tax; PIT = personal income tax; Subsoil rent = rent for the use of natural resources; VAT = value-added tax, collected from imports or domestic goods.

The role of tobacco excise revenues for the consolidated budget is increasing with the growth in revenues. The nominal excise revenues in 2023 grew by 38.9% compared to the pre-war year of 2021, exceeding the accumulated inflation and despite an estimated population decrease of 14%. This led to an increase in the share of the excise revenues in the state budget, from 5.7% to 7.3%.

Since 2022, the retail sales excise revenue that used to go to the state budget has been transferred to local budgets. The retail sales excise is an excise of 5% of the retail sales price. It was initially paid by retailers, but the obligation was shifted to importers and domestic manufacturers (based on the volume of sales and maximum retail sales prices) in order to improve tax compliance.

The excise is distributed by the State Treasury Service to local budgets, based on the share of registered retail sales in every local authority, as calculated by the State Tax Service for every month based on the data from the cash registers. The system has been designed in this way to stimulate local authorities to enforce the tax compliance of tobacco retail sales at the local level in order to boost the amount of tax revenues flowing into their budgets.

Figure 5 / Tobacco excise revenues and shares



Source: State Tax Service of Ukraine; authors' calculations

The only reliable sales data are on the volume of sales of tobacco products via cash registers, which are available for the period starting April 2023. For the last 12 months (ending in October 2024), the monthly sales averaged UAH 9.7 billion, or UAH 116.6 billion in annualised terms.

Based on market research conducted by Forbes Ukraine (Maranchak 2023), Table 1 summarises the main market players operating as of the end of the 2023.

Table 2 / Main market players, end of 2023

Company	Key brands (domestic production and imports)	Annual sales, in UAH bn (incl. exports)
Philip Morris	Marlboro, Heets, IQOS, Parliament, L&M	28-30
British American Tobacco	Vogue, Dunhill, KENT, Rothmans, Lucky Strike, Capri, Pryluky	29.6
JTI Ukraine	Camel, Winston, Glamour, Monte Carlo	22.5
Imperial Tobacco	Davidoff, West, Jade, Parker & Simpson, Imperial Classic, Pryma	9.6
Galychyna-Tabak	Sk, Estrada, Barge, Derzhavna, Grelka	6.9
Marvel	Marvel, Compliment, Strong, Lifa, Kyiv	6.4

Note: To avoid double counting, distribution companies without brands have been excluded.

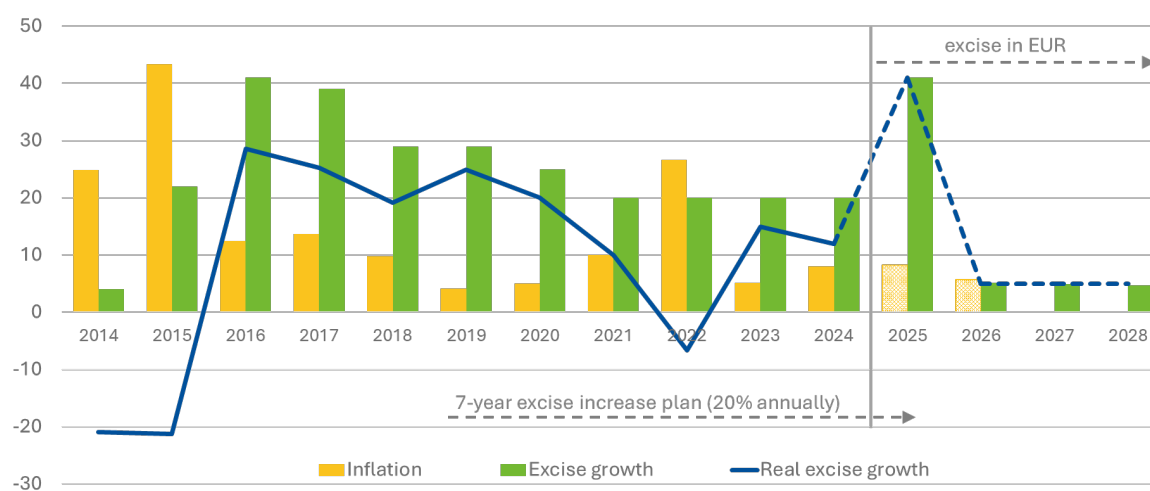
Source: Forbes Ukraine (Maranchak 2023); authors' calculations

5. Current and future excise tax design

In Ukraine, ad valorem and specific excise rates apply to tobacco products. The Tax Code also stipulates that the total tax obligation should not be lower than the minimal tax obligation set across different tobacco and nicotine products. Since the minimal tax obligation is higher in most cases than the tax obligation calculated according to the law, the minimal tax serves as the effective excise burden. Such a situation occurs due to the low ad valorem rate (12%), which only comes into play for the most expensive tobacco products.

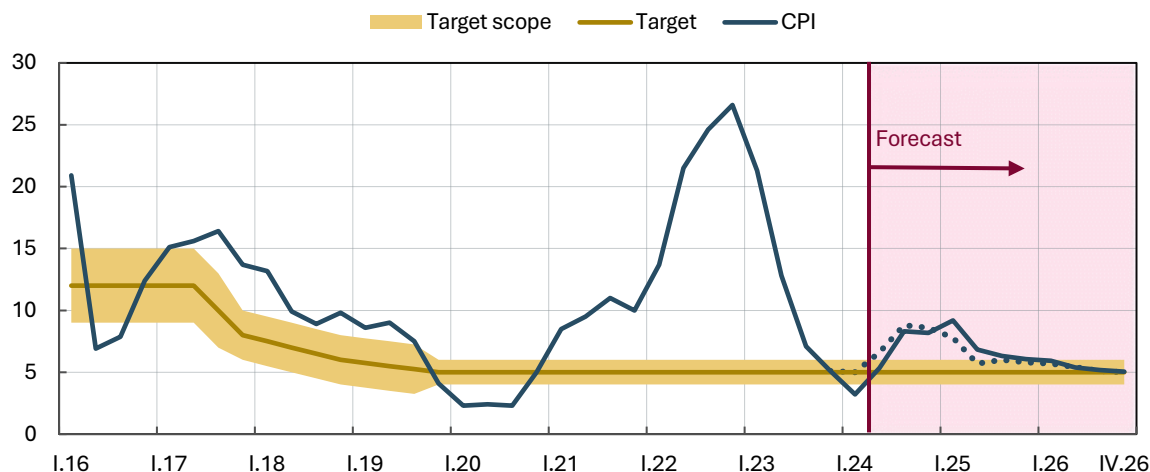
In December 2017, Ukraine approved a seven-year plan to increase the excise tax on tobacco products by 20% annually (VRU 2018). The measure aimed to ensure convergence with the EU Directive on the minimum excise tax liability of at least EUR 90 per 1,000 units by 2025. With subsequent amendments, lawmakers increased the specific excise by 30% in 2018 and by 29% in 2019 (first by 20% and then by an additional 9%) in addition to approving a schedule of 20% annual increases until 2025. Taking inflation into account, this schedule led to steady growth in the real excise rate, except for in 2022, when inflation in Ukraine reached 26%.

Figure 6 / Nominal and real excise rates changes, %



Source: NBU (2024); authors' calculations

Based on the NBU's (2024) macroeconomic forecast, we expect 8.2% inflation in 2024 as well as a slight decline (to 5-6%) in the coming years (while keeping in mind, of course, the fundamental uncertainty caused by Russian aggression).

Figure 7 / Actual and forecasted change in CPI (%)

Source: NBU (2024)

Since the current schedule did not allow the minimum level of taxation set by the EU's Tobacco Taxation Directive (EC Directive 2011/64/EU) to be achieved in time (i.e. by 2025), it became necessary to revise the excise tax rates in order to gradually reach this level by 2028. As a result, in June 2024, the Parliament of Ukraine approved a new tobacco excise law in the first reading that revised these tax rates accordingly while also making tobacco excise rate denominated in euros rather than hryvnias and boosting tax revenues (VRU 2024).

Among other positive legislative changes is the introduction of the specific excise for oral nicotine (i.e. nicotine pouches) at the level of the minimal excise for cigarettes less EUR 5 per kg. If translated into taxation per 1,000 items, it would be an equivalent to about EUR 59 per 1,000 items in 2028, when the minimal excise for cigarettes would reach EUR 90. As tobacco-free nicotine pouches may have the fewest harmful constituents of all tobacco and nicotine products (WHO 2023b: Section 4), such a preference may be reasonable. At present, only nine EU countries have introduced an excise for oral nicotine, with some examples of rates being 0.4 Czech koruny (CZK)/g in Czechia (approx. 16 EUR/kg) and 50 EUR/kg in Greece, which are both lower than the rate of 73 EUR/kg that will be applied in Ukraine in 2025.

Ukrainian lawmakers have also banned the sale of any flavoured e-cigarettes, which is intended to reduce the rate of initiation among children and young adults – under the premise that the sales of illicit flavoured e-cigarettes would be controlled.

As a downside, in the second reading of the tobacco excise law, lawmakers are expected to consider tax benefits for HTPs by decoupling HTP excise growth from that of cigarettes (Liga Zakon 2024; Slovo I Dilo 2024).

**Table 3 / Excise for tobacco products, increase schedule adopted in the first reading
(4 June 2024)**

Excise type	Unit	2021	2022	2023	2024	2024 in EUR	2025	2026	2027	2028
Specific excise		UAH	UAH	UAH	UAH		EUR	EUR	EUR	EUR
Cigarettes	1,000 pcs	1,089	1,306	1,568	1,881	41.3	58	61	64	67
Tobacco, oral nicotine products	1kg	1,368	1,641	1,970	2,363	51.9	73	77	81	85
HTPs	1,000 pcs	1,456	1,747	2,097	2,517	55.3	70.40	70.80	71.14	72.00
Liquids for e-cigarettes	litre	3,000	3,000	10,000	10,000	220				
Minimal excise										
Cigarettes	1,000 items	1,456	1,748	2,097	2,517	55.3	78	82	86	90
Ad valorem	%	12	12	12	12		12	12	12	12

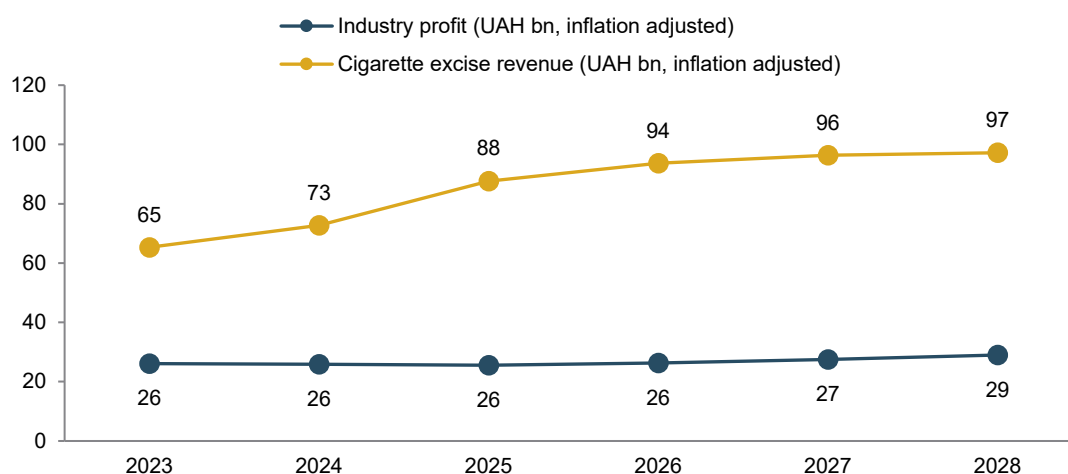
Source: VRU (2024); authors' calculations

6. Modelling the effects of an excise increase

The analysis of the fiscal impact of increasing tobacco excise taxes, based on the tax model developed by Fidanovski et al. (2024), shows that the inflation-adjusted excise revenues from cigarettes would increase from UAH 73 billion in 2024 to UAH 97 billion in 2028, while the industry's profits would remain mostly unchanged, returning to moderate growth in 2028. The smoking prevalence would decrease from 23.2% in 2023 to 22% in 2026, but then it will start growing slightly again to reach 22.3% in 2028.

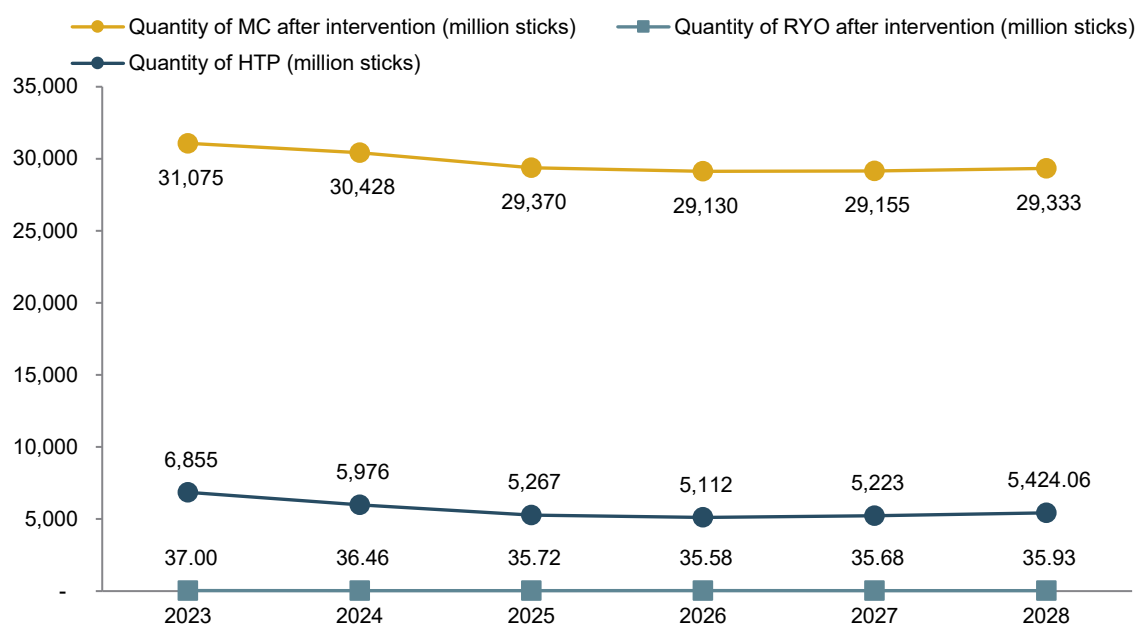
The new tax policy is predicted to avert more than 93,000 premature deaths by 2026, with the cumulative effect resulting in almost 80,000 premature deaths averted by 2028.

Figure 8 / Excise revenue and industry profit (UAH bn, real values)



Source: State Tax Service of Ukraine; authors' calculations

Modelling shows a notable decline in the consumption of manufactured cigarettes, falling from 31,075 million sticks in 2023 to 29,333 million sticks in 2028, which reflects a sustained decrease as a result of increased excises and shifts in consumer preferences towards alternative products. In contrast, if the excise decoupling is approved (see Table 3), the consumption of HTPs would show a slower decline, which suggests a partial shift in consumer behaviour away from traditional cigarettes. The initial HTP quantity drops from 6,855 million sticks in 2023 to 5,424 million sticks by 2028, but HTP consumption is projected to grow after 2026.

Figure 9 / Consumption after the intervention (sticks m)

Notes: MC = manufactured cigarettes; RYO = roll-your-own cigarettes; and HTP = heated tobacco products.

Source: authors' calculations

7. Domestic manufacturing capacities and imports

Collectively, the five largest producers of tobacco products in Ukraine pay 99.7% of domestic excise revenues. Among them, there are four multinational companies – British American Tobacco (BAT), Japan Tobacco International (JTI), Philip Morris International (PMI) and Imperial Tobacco – and one larger local plant. In addition, there are other international and regional companies that have minor production capacities in Ukraine.

Before Russia's full-scale invasion of Ukraine on 24 February 2022, PMI had a share of around 28.5% of the Ukrainian tobacco market (interfax Ukraine 2023). The company's production capacities were located in the Kharkiv region, where there was much fighting in 2022 as well as intense missile and artillery attacks after the liberation of the region in 2022. As a result, due to safety measures and logistical issues, the PMI plant in the Kharkiv region could not be used. PMI's market share dropped to 14% two months after the full-scale invasion. To continue its presence in the Ukrainian market, PMI imported products from its factories abroad and, in August 2022, it signed a contract with Imperial Tobacco to manufacture PMI products at the former's plant in Kyiv until December 2024 (RBC-Ukraine 2024). In October 2023, the CEO of PMI's operations in Ukraine reported that its market share had rebounded to around 24%, which is close to the pre-invasion level.

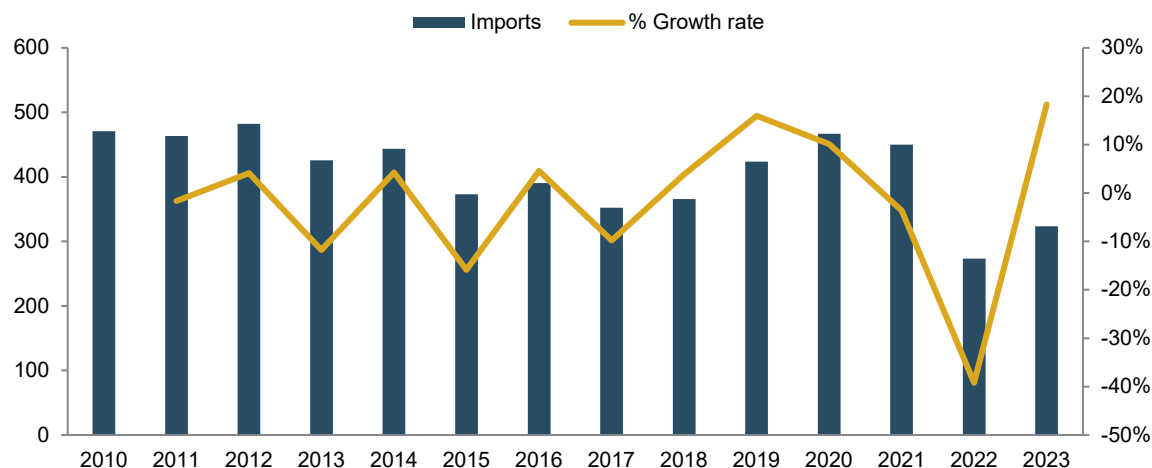
In May 2024, PMI opened a new plant in the Lviv region in Western Ukraine, which entailed an investment volume of roughly USD 30 million (PMI 2023). It took about one year from the first public mention of the plans for the new plant to when it entered into operation. The company plans to relocate some workers from its plant in Kharkiv to the new plant in Western Ukraine (PMI 2024a).

Table 4 / Domestic producers of tobacco products (production capacities and taxes paid) in 2023

	Production, sticks m		Taxes paid, UAH m				Taxes per tonne of raw tobacco, UAH m
	Cigarettes	HTPs	Excises	VAT	PIT	Total	
BAT	10,726	905	21,122	5,911	198	27,231	24.3
JTI	10,203	0	17,348	4,801	120	22,270	14.8
Imperial Tobacco	9,265	0	17,098	4,702	3	21,803	25.6
Vynnyky plant	1,244	0	4,831	810	66	5,707	7.7
Phillip Morris*	10,000**	n/d	24,000	6,400	n/d	n/d	n/d
Total	31,438	905	60,399	16,225	387	77,011	n/a

Sources: * PMI (2024b) ** PMI (2024a); authors' calculations

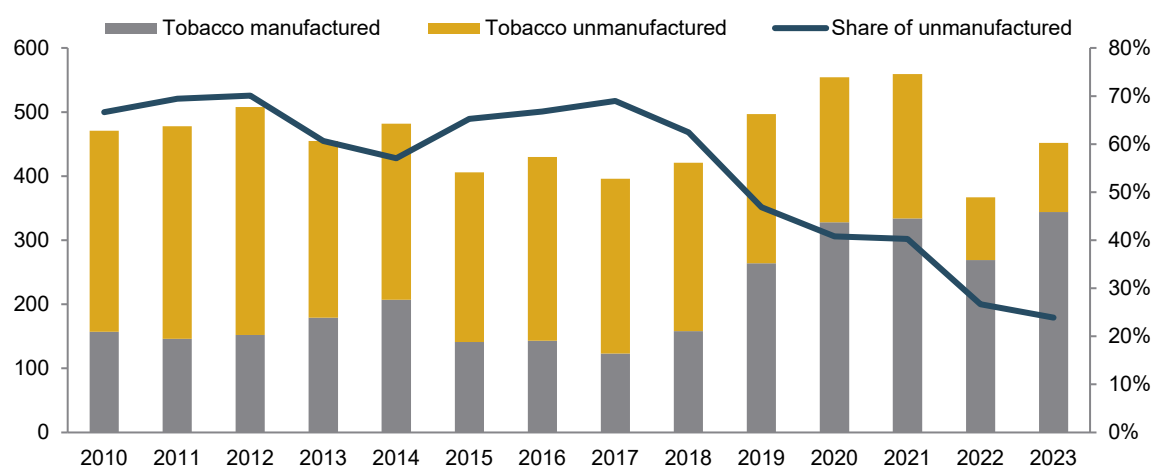
Figure 10 / Real value of imported tobacco products to Ukraine in USD m, 2010-2023 (2010 as base year)



Source: UN Comtrade Analytics; authors' calculations

Between 2010 and 2023, the volume of imported tobacco products to Ukraine decreased overall by USD 19 million, or by 4% in nominal values. In the 2010-2012 period, the import value of tobacco products showed a stable increase. In the 2013-2017 period, the protracted declining trend dominated the market, with minor fluctuations. Two of the main reasons for the contractionary trend were the weakening of the hryvnia against the US dollar in the 2014-2015 period and the fact that domestic production partially made up for the lower volume of international trade with Russia. In the 2017-2021 period, the market recovered from the previous downturn and grew sharply, by 41%. In 2021, the value of imported tobacco products in nominal values reached a peak of USD 559 million. Due to Russia's full-scale invasion of Ukraine, imports of tobacco products declined by more than 34% in 2022, reaching its lowest point (USD 367 million in nominal terms). In 2023, the value of imports recovered by 23% compared to the previous year, rising to USD 452 million in nominal terms.

Figure 11 / Structure of tobacco products imports in Ukraine, in USD m, 2010-2023

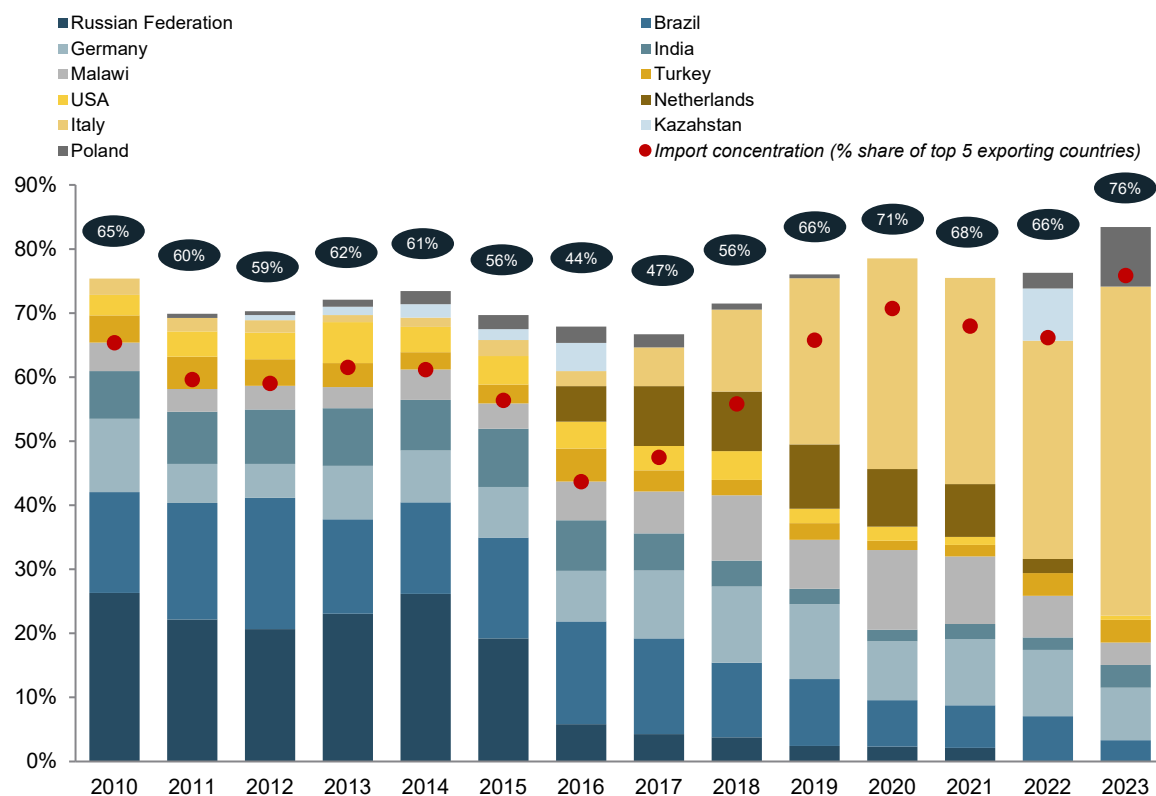


Source: UN Comtrade Analytics; authors' calculations

Due to relatively low production costs and peculiarities of the production process, raw tobacco (i.e. not stripped tobacco, wholly or partly stripped tobacco, or tobacco refuse) dominated the structure of imported tobacco products to Ukraine in the 2010-2018 period. During this period, the share of unmanufactured tobacco fluctuated between 57% and 70% of overall imported tobacco products. However, since 2019, the share of unmanufactured tobacco products has been below 50%, demonstrating the steady downturn trend. This tendency is linked with the fact that international partners are uncertain about investing in production in the country given the ongoing war and economic instability.

Since 2022, some manufacturers' plants have been destroyed or damaged by Russian strikes, which has forced these companies to import tobacco products to maintain their share of the Ukrainian market. This fact explains the tendency of the decreasing share of unmanufactured tobacco in the structure of Ukraine's imports of tobacco products.

Figure 12 / Countries with the largest exports of tobacco and tobacco products to Ukraine



Source: UN Comtrade Analytics; authors' calculations

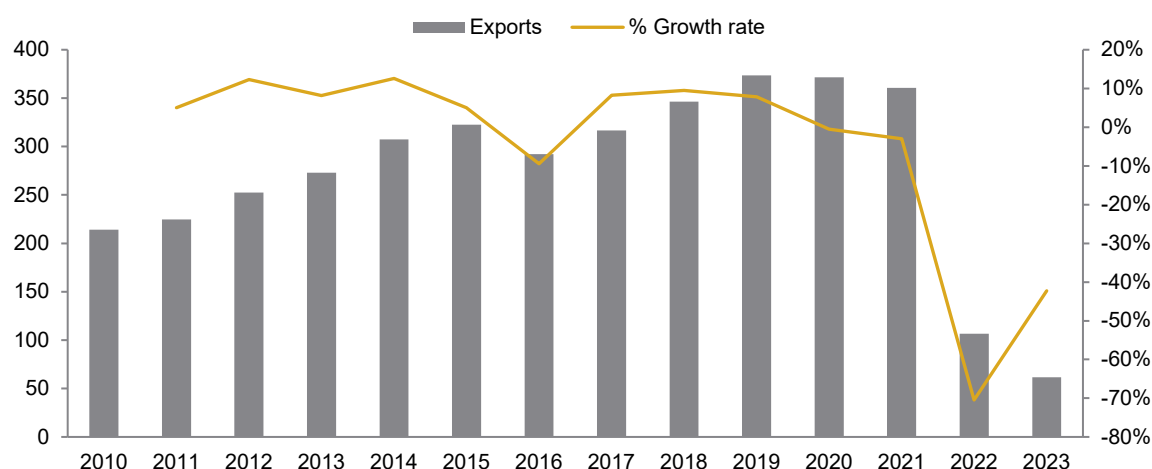
During the 2010-2014 period, Russian tobacco products constituted 20-26% of Ukrainian imports of tobacco products. However, after the beginning of Russian-Ukrainian war in February 2014, the Russian share started declining and trade volumes between two countries began to decrease. Since 2022, no Russian tobacco products have been imported into Ukraine.

Since 2017, the import of tobacco products to Ukraine from Italy has increased significantly. Moreover, in the 2019-2023 period, Italy's share in Ukraine's total tobacco imports has not dipped below 25%. This

upward trend of an increasing share of imported tobacco products from Italy is explained by the overall increase of Italian exports of tobacco products in the 2017-2023 period. This happened because big international manufacturers of tobacco products invested billions of euros in the Italian tobacco industry. At the same time, Germany and Turkey have been Ukraine's relatively stable international trade partners, as the absolute and relative values of imports of tobacco products from these countries have not significantly changed over the last 14 years.

Import concentration is a ratio that demonstrates whether a small number of countries generate most of the imports or whether it is spread out over a very large number of countries. In our chart, we calculated the shares of the top five importers of tobacco products to Ukraine for each year to illustrate import concentration. Between 2010 and 2016, import concentration decreased from 65% to 43%, meaning that the five leading importers of tobacco products to Ukraine were generating a higher share of total tobacco imports in 2016 than they did in 2010. However, between 2017 and 2023, Ukraine experienced an upward trend of import concentration of tobacco products, which reached its peak in 2023 at the level of 75%. This resulted from Italy's growing share in Ukraine's imports of tobacco products.

Figure 13 / Real value of exported tobacco products from Ukraine in USD m, 2010-2023 (2010 as a base year)



Sources: UN Comtrade Analytics, authors' calculations

Between 2010 and 2021, the volume of exported tobacco products from Ukraine increased by 68% in real terms. Thus, the value of exported tobacco products demonstrated a stable growth trend with minor fluctuations over 12 years. In 2022, after Russia's full-scale invasion of Ukraine, the latter's exports of tobacco products declined by 70% in real terms compared to the previous year. In 2023, in contrast to imports, exports did not start reviving and continued a downward trend, decreasing by 42% in real terms. Overall, during the first two years of Russia's full-scale invasion, Ukraine's exports of tobacco products decreased by more than 80%.

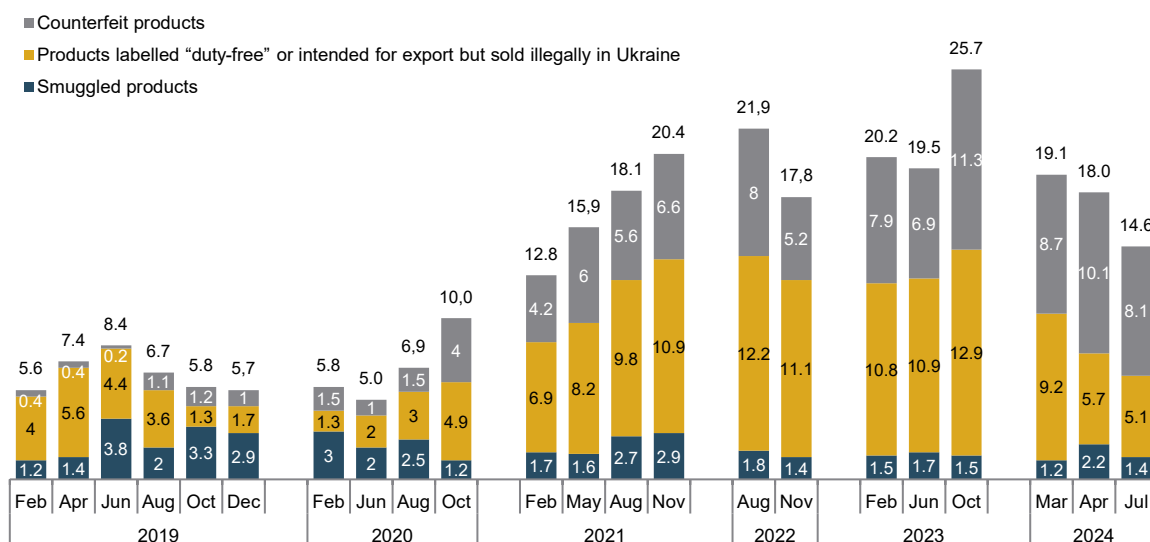
8. Illicit manufacturing and sales

Despite the strong public demand to finance military needs, Ukrainians also expect to avoid rising taxes on consumption and have asked for this to be achieved by fighting illicit sales and closing loopholes in the tobacco industry. Nevertheless, tobacco excise increases are well accepted.

According to Kantar Ukraine³ surveys (Kantar Ukraine 2024a, 2024b), which are carried out on behalf of the leading domestic tobacco manufacturers, the level of illegal trade of tobacco products in Ukraine was 19.1% at the beginning of 2024. Annual budget losses are estimated to be UAH 24 billion. From October 2023 to March 2024, the share of counterfeit products decreased (to 8.7%), as did the share of products labelled 'duty-free' or intended for export but sold illegally in Ukraine (to 9.2%). These two decreases may have been the result of investigations into activities of the Vynnyky Tobacco Factory. In addition, it is essential to highlight that despite the decline of the level of illegal trade of tobacco products compared to the previous year, the level of 19.1% is still historically high.

Most of the tobacco products (57%) that were labelled 'duty-free' or intended for export but illegally sold in Ukraine have had an inscription stating that they were manufactured at the Vynnyky Tobacco Factory. Almost half of this group of illegal products are Compliment brand cigarettes with duty-free labelling (45%).

Figure 14 / Illicit tobacco sales in Ukraine by categories, % of total sales



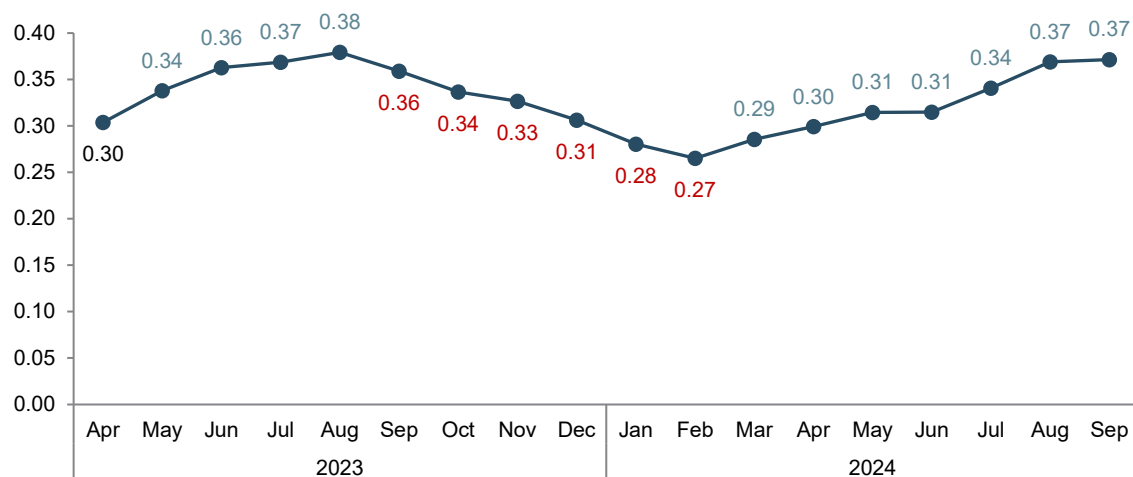
Sources: Kantar (2024b)

³ Kantar Ukraine is a commercial entity that conducts the project 'Monitoring of the illegal trade of tobacco products in Ukraine' at the request of leading domestic tobacco manufacturers. The study is conducted four times a year, and the research methodology is only partially disclosed.

The distribution of illicit tobacco products is conducted through kiosks (33%), shops (30%), street vendors (19%) and street markets (13%). Another sales channel is online platforms, especially via groups in Telegram Messenger. Our monitoring shows that online sales have been experiencing supply issues in recent months, likely due to investigations into the activities of the Vynnyky Tobacco Factory.

The monthly retail sales volumes data, obtained from the State Tax Service (available starting April 2023) indicate significant fluctuations (of up to 40%) from the lowest level, which was reached in February 2024. As the data series is limited, we cannot adjust it for seasonality and make reliable conclusions about changes in illicit sales. It should be noted that studies confirm the seasonality of cigarette consumption in regions with a continental climate, especially where an indoor smoking ban is in effect, as is the case in Ukraine. Under such conditions, smokers may tend to decrease their consumption intensity during cold months or use alternative nicotine products.

Figure 15 / Average daily sales of tobacco by volume and month, cash registers data, UAH bn



Source: authors' calculations

The level of 'products for sale or marked as 'duty-free' but sold in Ukraine' was relatively stable in the 2022-2023 period, ranging between 10.8% and 12.9%. But this indicator dropped to 5.7% in April 2024 (Kantar 2024a). The reason for this change is likely the law that came into force on 1 October 2023. Until martial law is lifted in Ukraine, this law prohibits (i) the production for sale of tobacco products and e-cigarette liquids in a duty-free zone and (ii) the sale of tobacco products and e-cigarette liquids in duty-free shops. In addition, a draft law aims to prevent unreasonable losses of raw materials that could be used to manufacture illegal tobacco products. In addition, the Parliament of Ukraine's Committee on Finance, Taxation and Customs Policy has developed a system for tracking tobacco products (known as 'e-Excise'), which is based on European Integration Directive 2014/40/EU (Koshchuk and Pasichnyi 2024; Rubryka 2024). With e-Excise, Ukraine will have a tracking system similar to the European Track & Trace (T&T) system for tobacco products, which has been operating in the EU since 2019. The system will store information about each unique identifier applied to excise products, thereby making it possible to track the movement history of each specific product.

In Ukraine, there is also a problem with selling products with counterfeit excise stamps through official distribution networks. It is not easy to distinguish such stamps from genuine ones without close

examination. The solution to this problem will be an electronic excise stamp represented by a two-dimensional Data Matrix code. Producers and importers will be able to generate electronic excise stamps in the digital tracking system (e-Excise) and place them on their products. In this way, the government will receive complete information about the entire supply chain, while consumers will be able to ensure they are not buying counterfeit products. Moreover, after the introduction of e-Excise, all duty-free alcohol and tobacco products will be subject to mandatory labelling. When drafting the bill, the leading European norms on labelling and monitoring the movement of excisable goods were taken into account. The launch of the system is planned for January 2026 (epravda 2023).

9. Conclusion

The Ukrainian tobacco market has several characteristics that make it unique when compared to other markets in the European Union and elsewhere.

The highest rate of daily consumption is among the youngest age group (18-29 years), which may suggest a potential upward trend in smoking prevalence. While cigarettes remain the most popular product overall, younger adults show a more even consumption of cigarettes, heated tobacco products (HTPs) and e-cigarettes.

Excise tax policies have played a crucial role in shaping the market. Ukraine has implemented a plan to increase excise taxes on tobacco products, aiming to align with EU directive. Recent legislative changes include a new law that denominates excise rates in euros and has a front-loaded increase schedule to now reach the minimum EU requirements by 2028, after the previous schedule failed to meet its goal by 2025 due to a stronger-than-forecasted devaluation of the hryvnia. The introduction of an excise for oral nicotine pouches also represents a significant step towards better regulation of new nicotine products. However, excise taxes on HTPs have been decoupled from those on cigarettes, which is projected to lead to a shift in consumer behaviour and potential budget losses.

Ukraine's tobacco market is dominated by four multinational companies and one larger local plant. Despite the large tax revenues generated from tobacco sales, there is a significant issue with illicit sales, which are estimated to make up between 10% and 20% of the market. These illicit sales are primarily conducted through kiosks, street vendors and online platforms, highlighting a need for stronger enforcement and stricter market controls.

The structure of demand should also be carefully considered in policy design. Cigarettes are the most commonly used product (68.7%), followed by HTPs (22.8%) and e-cigarettes (15.8%). There is a notable correlation between income and consumption, with higher-income individuals being more likely to use tobacco products in general and HTPs specifically. Furthermore, there are notable differences in tobacco and nicotine product usage among men and women as well as across age groups, regions and settlement sizes.

The Ukrainian government has taken steps to combat illicit trade, including a law prohibiting the sale of tobacco products in duty-free shops, as these are used to channel the tax-free tobacco to the illicit domestic market. The development of a tracking system (e-Excise) similar to the one in the EU is also underway and is expected to improve the tracking of tobacco products and to combat the sale of counterfeit products.

The modelling of excise increase effects shows that inflation-adjusted excise revenues from cigarettes are projected to increase from UAH 73 billion in 2024 to UAH 97 billion in 2028. The model also projects a decline in smoking prevalence but a slight increase after 2026 and a significant reduction in premature

deaths due to the increase of excise taxes. The consumption of manufactured cigarettes is expected to decrease, with a potential shift towards alternative products (e.g. HTPs).

Key recommendations:

- › Increase the excise for HTPs to the minimal level for cigarettes in order to minimise budget losses and to align with the excise policy goals.
- › Strengthen measures to combat illicit sales through stricter local-level enforcement, online monitoring and tracking systems.
- › Implement and enforce the e-Excise system to track tobacco products and curb illicit trade more effectively.
- › Continue data-based monitoring and assessing of the impact of tax policies on smoking prevalence and budget revenues.
- › Conduct more research on the use of multiple products as well as the influence of income and geography on tobacco and nicotine consumption patterns so as to better inform policy makers.
- › Assess the impact of the ban on flavoured e-cigarettes.

These measures will help to achieve the objectives of both reducing tobacco consumption and increasing budget revenues in Ukraine.

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