

## Guidelines for FCTC Article 6 (Price and tax measures to reduce the demand for tobacco) – *What Finance Ministries need to know*

Fourth session of the Conference of the Parties to the WHO Framework Convention on Tobacco Control, 15-20 November 2010, Punta del Este, Uruguay

*Tobacco taxes are an effective measure in many ways: they have clear fiscal as well as health benefits; they generate revenues, and at the same time are supported by economists, other experts, and the public alike. In today's climate, many governments are under strong pressure to find new sources of revenue, but it is important to do so as effectively as possible, minimising economic distortions and administrative burden.*

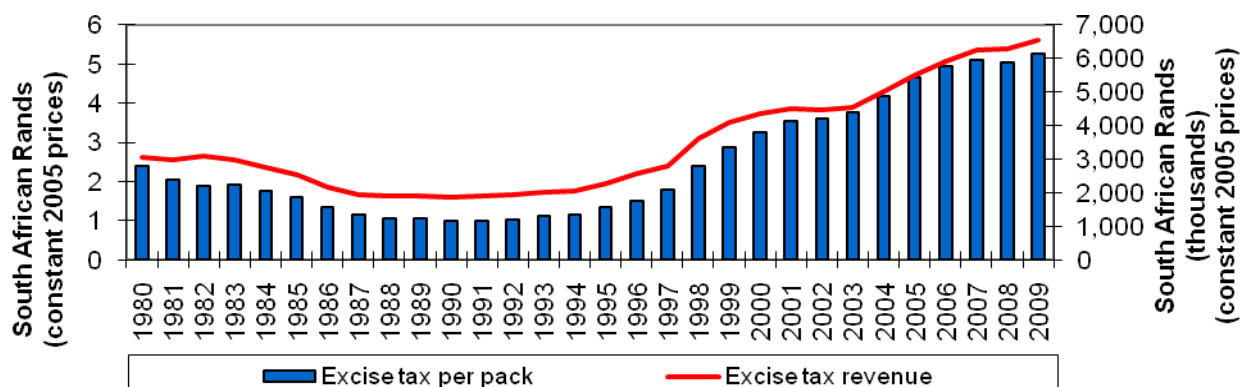
*Implementing taxes recommended by an international treaty that has high acceptance worldwide – the Framework Convention on Tobacco Control (FCTC) – will result in greater legitimacy and acceptance, which will facilitate the introduction, or increase, of taxes.*

*The Framework Convention Alliance (FCA) suggests that the Conference of the Parties (COP) set up a working group to develop guidelines on Article 6. These guidelines would significantly facilitate national initiatives to simplify and increase tobacco taxes. At the same time, a working group which includes finance officials would tremendously raise the profile of the treaty and provide an opportunity for finance ministries to make a significant contribution to advancing global public health.*

### Tobacco taxes are a highly reliable and predictable source of revenue

In general, increases in consumption taxes have an immediate positive impact on budgetary revenues. However, over time tax revenues may fall as the consumption of the taxed goods drops. Because tobacco products are highly addictive and have no obvious substitutes, demand for them falls more slowly in the face of price increases. In economic terms, this feature is explained by the idea of price elasticity (responsiveness) of demand. The demand for tobacco products has proven to be relatively inelastic. For instance in Mexico, a 10% price increase (due to an imposed tax) reduces demand by only 4.8%, i.e. a price elasticity of demand of -0.48<sup>1</sup>. Tobacco taxes secure a steady level of tax revenues not only in the short term, but also in the medium term.

### South Africa



**Source:** Van Walbeek (2005), updated with data from National Treasury

<sup>1</sup> Jimenez J-R et al., "The Impact of Taxation on Tobacco Consumption in Mexico", Tobacco Control, published online February 19, 2008.

South Africa provides an excellent example of tobacco tax revenue predictability. The chart above portrays the country's tobacco tax revenues [in red] and tobacco excise tax rate [in blue] from 1980 to 2009. Between 1980 and 1991, tobacco (excise) taxes declined in real (inflation-adjusted) terms and tax revenues decreased. Since then, the Government of South Africa has introduced new tax policies resulting in regular (annual) increases of tobacco taxes. Consequently, tax revenues have grown steadily, more than doubling from their 1991 levels.

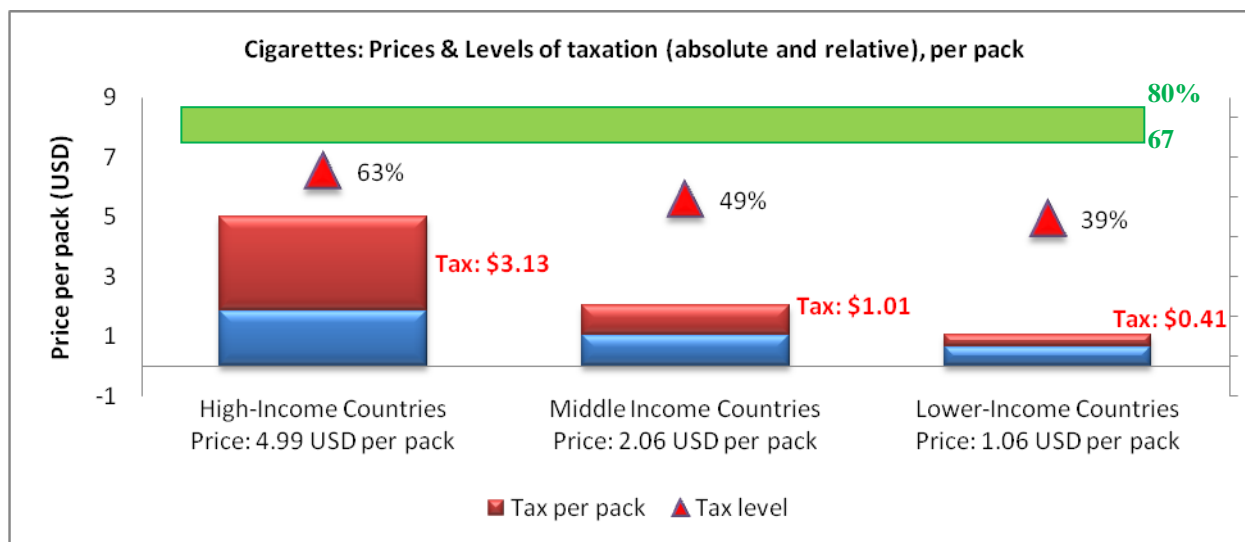
### Every country benefits from tobacco taxes

Economic and social conditions differ in every country. However, tobacco taxes have shown clear financial benefits when implemented in developing and developed countries alike. In developed countries, statistics show only a 4% drop in demand after a 10% price increase<sup>2</sup>. This leads to steady and predictable tax revenues in the short, medium, and even long term.

Developing countries have even greater opportunities to collect higher revenues from tobacco taxes, for the following reasons:

- **In part because of increasing affordability of tobacco products, their consumption is widespread:** During recent decades, many developing countries experienced high economic growth and/ or high inflation. However, the general increase in prices has not been reflected in the price of tobacco products, making them more affordable to the general public<sup>3</sup>. Hence, a tobacco tax can now be applied to a wider taxation base.
- **The room to raise taxes is obvious:** Tobacco taxes are generally low in developing countries, in absolute and relative terms. For cigarettes, studies have recommended a tobacco tax level of 67%-80% [the green bar in the chart below] of the retail price per pack<sup>4</sup>. However, many countries [in red] have not harnessed this potential yet. The uncertain environment following the economic crisis provides an opportunity to do so.

Developed and developing countries alike would benefit from FCTC guidelines on tobacco taxes. Because of the legitimacy that they would carry – coming from an international treaty – those guidelines would not only strengthen the argument for tobacco taxes, but also smooth their implementation or increase.



Source: WHO Report on the Global Tobacco Epidemic, 2009, p. 58 & World Bank, 1999

<sup>2</sup> Cf. World Bank, "Curbing the Epidemic: Governments and the Economics of Tobacco Control", 1999.

<sup>3</sup> Blecher EH & Van Walbeek CP, "Cigarette Affordability Trends: An Update and Some Methodological Comments" Tobacco Control 18(3): 167-175, 2009 or Blecher EH, "Targeting the affordability of Cigarettes: A New Benchmark for Taxation Policy in Low-Income and Middle-Income Countries Tobacco Control 2010 19: 325-330, 2010

<sup>4</sup> Cf. World Bank, Curbing the Epidemic: Governments and the Economics of Tobacco Control, 1999.

### **Lower tax burden on the poor and youth makes tobacco taxes even more appealing**

Responsiveness to prices is particularly high among the poor and youth. This is understandable: a poor person is more price sensitive than an affluent one since the cost of consumer goods makes up a greater proportion of their income. Similarly, a young person (usually with a limited income) will be more sensitive to price changes, or will be discouraged by the higher price from buying tobacco products in the first place. Hence, by buying less, poor and young people will pay a smaller proportion of the new tobacco taxes. As a result, a tobacco tax increase actually shifts the tax burden from poorer to richer households. In economic terms, this means that a tobacco tax increase is actually a progressive measure<sup>5</sup>. For these reasons, tobacco taxes have qualities that are widely accepted by economists and civil society, as well as the general public.

### **Flawed arguments against tobacco taxes**

The evidence clearly shows that tobacco taxes will boost overall tax revenues and have additional macroeconomic benefits. For obvious reasons however, the tobacco industry has successfully misrepresented the link between tobacco taxes and smuggling, or the illicit trade in tobacco products.

To prevent and combat illicit trade, other measures – not lower taxes – have to be adopted. Spain is an excellent example of a particularly effective strategy. Between 1997 and 1998, Spain joined forces with neighbouring countries and reduced the supply of smuggled contraband by better controlling its borders<sup>6</sup>. Strategies focused on reducing the supply of smuggled cigarettes at the container level, cooperating with countries where contraband originated, rather than suppressing distribution at the retail or street level.

There are proven, effective measures for combating illicit trade in tobacco products, including strengthening intelligence, increasing customs activity, and developing international collaboration. In addition, countries have already advanced considerably in negotiations for an Illicit Trade Protocol (ITP) under the FCTC, making it a particularly opportune moment to introduce higher tobacco taxes.

### **Finance Ministries can save lives**

Tobacco is costly to society in many ways. Smokers have higher absenteeism rates than their non-smoking peers. Furthermore, significant health care costs are associated with the treatment of smokers who fall ill. In this respect, tobacco taxes are a very effective measure to prevent deaths and illnesses caused by smoking. For example, if Russia chose to raise tobacco taxes so that they account for 70 percent of the retail price, as many as 2.7 million tobacco-related deaths could be avoided among the current Russian population<sup>7</sup>. Additionally, higher tobacco taxes would reduce costs associated with tobacco use and smoking, such as increased absenteeism and costs for nonsmokers who fall ill due to exposure to second-hand smoke. Higher tobacco taxes will also reduce environmental costs originating in tobacco growing and processing, such as deforestation and environmental degradation.

Higher tobacco taxes save lives. By championing and participating in the development of guidelines for tobacco taxes, Finance Ministries will make a significant contribution to global public health.

### **Tobacco taxes: options & opportunities**

There are various ways to implement tobacco taxes, and they do not require additional administrative infrastructure. Tobacco taxes can be collected in many ways. Currently, four main types of tax collection are used worldwide:

- **Excise taxes:** Typically applied to goods (imported or domestic) in a particular product category, often at point of production/ import, excise taxes may take the form of a set amount per unit of product (specific tax) or a percentage of product value (ad valorem tax);
- **VAT:** Value Added Taxes are widely adopted consumption taxes;
- **Retail sales taxes:** Retail sales taxes are charged only on final sale (hence the name) and are now largely restricted to the United States;
- **Import duties:** commonly used by countries in the form of tariffs levied on imported cigarettes.

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<sup>5</sup> WHO Technical Manual on Tobacco Tax Administration, 2010.

<sup>6</sup> Joossens L, “Report on Smuggling Control in Spain”, undated.

<sup>7</sup> Ross H, Shariff S, and Gilmore A, “Economics of Tobacco Taxation in Russia” Bloomberg Initiative to Reduce Tobacco Use, 2009.

The existing variety of taxation schemes provides an array of benefits. Most importantly, different tax collection mechanisms allow for the development of policies which reflect local conditions and priorities. Additionally, given the flexibility of tobacco taxes, each country already implements some kind of taxation scheme. As a result, increasing taxes does not result in additional administrative costs.

Tobacco tax policies have become more uniform over recent years. For instance, due to the implementation of various trade agreements, import duty rates on tobacco products have been reduced in many regions. This trend calls for greater involvement of Finance Ministries to share their experiences and best practices at a global forum like the working group on Article 6 guidelines.

### **Guidelines Development**

Finance Ministries have an important role to play in the FCTC process. Article 6 of the treaty recognises the importance of tobacco tax measures for tobacco control and public health. Finance Ministries have both the expertise and a clear vested interest to be deeply involved in discussions of this matter. Participation in guidelines development will provide Finance Ministries with many benefits:

1. **Support for tobacco taxes:** The development of guidelines will facilitate the increase and simplification of tobacco taxes at the national level, institutionalising the process and securing support from economists, international financial organisations and civil society.
2. **A global forum to discuss ideas and approaches:** In today's globalised world, calls are growing for a more coordinated approach between states regarding various matters – taxes included. The guidelines development process guarantees that during such negotiations each country (Party) can share its experiences and raise its concerns.
3. **Build on achieved progress:** Finally, the Parties have already decided to deal with illicit trade, and are negotiating the Protocol under the FCTC. Thus, it is an ideal time for the development of guidelines on taxes, a process that should involve Finance Ministries.

### **Conclusion**

The FCTC addresses tobacco control globally, and has been perceived as focusing on health issues. To become more effective however, tobacco control has to actively engage other fields and have a sound economic basis. Given the current economic climate, advanced negotiations of the ITP, and the need for fresh perspectives, now is the right time for Finance Ministries to join the FCTC process by participating in the development of guidelines for Article 6.