



This document relates to item 6.1 of the provisional agenda.

Fifth Session of the Conference of the Parties to the  
WHO Framework Convention on Tobacco Control, 12-17 November 2012, Seoul, South Korea

### **FCA Policy Briefing: Article 6 draft guidelines**

#### **Key recommendations**

- It is important to adopt Article 6 guidelines at COP5;
- Some modifications should be made to improve the draft guidelines, particularly in discussions of tax structures, illicit trade and the use of revenues from tobacco taxes;
- Parties should also give thought to the data collection and technical assistance needs for implementation of Article 6, as well as to possible changes to the FCTC reporting instrument; an expert report should be requested on these topics.

#### **Introduction**

Tobacco tax increases are widely recognized as the single most effective tobacco control intervention, particularly in achieving both immediate and long-term decreases in consumption and in youth prevalence. Unlike many other interventions, they can be implemented repeatedly.

However, Article 6 implementation has been uneven and insufficient since the FCTC came into effect in 2005. A significant obstacle is institutional: health ministries generally bear primary responsibility for tobacco control, but have little if any input into tax policy. Finance ministries frequently treat tobacco excise taxes as one of several indirect taxes, without a full appreciation of their health and revenue benefits.

To add to this problem, the tobacco industry has a very strong interest in convincing governments to pursue low-tax policies. Tobacco companies typically invest considerable lobbying energy in defeating tobacco tax proposals, using both political contacts – sometimes at the highest levels of government – as well as contacts in the civil service. Frequently, this involves arguing that any tobacco tax increase would be self-defeating, as it would lead to an explosion in illicit trade in tobacco products, resulting in a decline in tax revenues and an increase in youth smoking. These arguments have repeatedly been debunked, but the tobacco industry continues to ‘sell’ its misinformation.

An additional difficulty in some Parties is the existence of complex tobacco tax structures, for example systems that feature multiple tax tiers for cigarettes, such as different rates for filtered and unfiltered cigarettes, for different lengths of cigarettes, for ‘premium’ versus ‘regular’ brands and so on. Some tax structures can reduce the effectiveness of tobacco tax increases, which may simply result in shifts from one market segment to another, with little decrease in consumption or increase in revenue.

On such technical issues, guidance from the FCTC Conference of the Parties, in the form of implementation guidelines, can play a very positive role.

It is worth noting that the Article 6 working group had the most members of any intersessional working group in FCTC history,<sup>1</sup> with significant representation from all regions. Encouragingly, the working group included a roughly equal mix of health ministry and finance ministry officials, contributing to both technical accuracy and a focus on public health.

## **Positive features of the draft Article 6 guidelines**

### **1. Guiding Principles**

The draft guidelines correctly identify tax and price policies as an “essential element of tobacco-control policies”. The guiding principles point out one of the key economic rationales for higher tobacco taxes: the externalities of tobacco use, both in the form of direct health-care costs and the high indirect costs, for example due to the death of productive workers in middle age.

Guiding principle (iv), highlighting both the economic efficiency argument for tobacco taxes as well as their effect in reducing health inequalities, is of particular note.

The working group should also be commended for emphasizing the importance of protecting tobacco tax policies from vested interests, in line with Article 5.3. It is important to note that tobacco tax policy is an integral part of the “public health policies” to which Article 5.3 and Article 5.3 guidelines apply.

### **2. Relationship between price and consumption/prevalence (2.1); Taxation and affordability (2.2)**

The draft guidelines provide a succinct and useful discussion of the price and income elasticity of demand for tobacco products, including references to the most recent and relevant scientific evidence.

The discussion of affordability is particularly welcome, due to the situation in a number of Parties that are experiencing rapid income growth at present, some of which are “hot spots” for the global tobacco epidemic. Large tobacco tax increases are needed in such countries to ensure that the otherwise very positive trend of higher incomes does not lead to the negative side-effect of increasing death and disease from tobacco.

### **3. Long-term national policies, including targets for tax rates (3.2)**

It is encouraging that the working group included the recommendation that “Parties should establish coherent long-term policies on their tobacco taxation structure including targets for their tax rates, in order to achieve their objectives within a certain period of time.”

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<sup>1</sup> Working Groups Established by the Conference of the Parties. WHO. [http://www.who.int/fctc/protocol/guidelines/working\\_groups/en/](http://www.who.int/fctc/protocol/guidelines/working_groups/en/). Accessed 12 Oct. 2012.

As mentioned, Article 6 is a crucial aspect of the FCTC, and its implementation requires a *sustained effort* with clear public health objectives. National policies and targets will naturally vary, depending on the state of the tobacco epidemic and economic conditions for each Party, but the principle that Parties should each have an explicit and long-term tax policy is very important.

We recommend, for the sake of clarity, specifying health as the objective. This would make this recommendation consistent with the wording of Article 6 itself, which talks of implementing tax and price policies “so as to contribute to the health objectives aimed at reducing tobacco consumption”.

**4. Comprehensiveness/similar tax burden for different tobacco products**

The draft guidelines rightly point out the importance of structuring taxes so as to maximize the public health impact of tax increases. Many countries have lower taxes on cigarette substitutes such as roll-your-own tobacco, resulting in ‘down-trading’ that partially defeats both the health and revenue objectives of tax increases. The same applies in Parties that have a significant share of water-pipe, bidi and other non-cigarette categories.

**5. The need for transparency and data**

As noted in section 8 on international cooperation, “as a basis for any policy and regulatory measures, transparent and sufficiently comprehensive data are needed.” The reality in many Parties is that the tobacco industry seeks to take advantage of the *lack* of data in order to convince governments not to increase taxes. This is an area where the COP might wish to consider further work, once Article 6 guidelines are adopted. (See *Future Work*, in this brief.)

**Areas that could be improved**

[For alternative wording, please consult the companion document – FCA side-by-side of draft Article 6 guidelines, and recommended improvements.]

**1. Simplification of discussion on taxation structures**

The third section of the draft guidelines, entitled *Tobacco Taxation Systems*, provides lengthy discussions of specific, ad valorem and mixed excise tax systems. This is a core subject of the guidelines, and it is important to strike a balance between a very high-level analysis which provides limited practical guidance and an overly detailed presentation which may not apply in many parts of the world.

In FCA’s view, the discussion relies too heavily on the experience of the European Union and its tobacco tax directive. While the EU has achieved a great deal through this directive, which has doubtless saved many thousands of lives, other Parties have also achieved considerable success with quite different systems. This is particularly an issue in the discussion of mixed systems (3.1.4) and of systems with minimum rates (3.1.5), where the draft goes beyond a general exposition of the policy options available into advocacy for a particular approach. For example, there are references to “a well-balanced, fair tax architecture” and to the “positive experience... gained by making wide use of a mixed system with minimum rates (specific and ad valorem)”. In section 3.2, the discussion of “most popular price category” versus “weighted average price” is probably not relevant to most Parties.

A related issue are the references to the impact of different tax structures on corporate pricing strategies. In the discussion on specific excise duty, for example, there is a reference to manufacturers' margins; in the following section (on ad valorem) to the "comparable treatment of all market players"; in the section on mixed systems to the "balanced taxation of all brands and to a level playing field among manufacturers." While it is sometimes relevant to consider the impact of different tax structures on manufacturer profitability, the draft does not provide an objective analysis of the advantages and disadvantages of various scenarios; instead, in this respect, it reads like an effort to justify the specific choices made by the European Union.

In FCA's view, the policy advice with respect to tax structures should be simplified to focus on two main points:

- On balance, specific taxes on cigarettes (and other tobacco products sold by the stick) are to be preferred for most situations; Parties with exclusively ad valorem systems should consider, as a first step, adding a specific component;
- Multi-tier structures (particularly multiple tax rates for different subcategories of cigarettes) are problematic for both health and revenue reasons and should be simplified to the extent possible.

#### **a) Problematic references to illicit/cross-border trade**

As mentioned, the threat of increased illicit trade is frequently used by the tobacco industry as an argument against tobacco tax increases. While illicit trade is indeed a significant issue for some Parties, this session of the COP is expected to adopt a Protocol on the issue, which should provide a policy recipe for Parties facing such challenges.

Keeping tobacco taxes low is *not* an appropriate response to illicit trade, or to the prospect of illicit trade, and it is important that the guidelines should not inadvertently encourage this type of policy response.

Specifically:

1. Section 3.1.4, on mixed specific/ad valorem systems, makes the claim that "a mixed system can also help to prevent a situation of purely specific taxation in one country and purely ad valorem taxation in a neighbouring country, which would result in cross-border flow of premium (expensive) brands from one country to a second one with cheap brands flowing in the other direction." This may be relevant in the Schengen zone, where border controls are absent and cross-border shopping routine, but is an unlikely argument for many other parts of the world.
2. Section 3.2 mentions that "Low excise levels in the RSP [retail sales price], as well as large gaps within regions or between neighbouring countries, have a number of negative effects such as cross-border flows and increasing illicit trade...". It is crucial to avoid suggesting that tax differentials between neighbouring countries *automatically* lead to increases in illicit trade. In fact, much of the illicit trade in the world involves *untaxed* product; smugglers of *untaxed* product don't care about the tax rate in the source country, as they aren't planning to pay taxes anywhere.

3. The recommendation at the end of Section 3.3 (which deals with the need for similar tax burdens across different tobacco products), claims that equalization of rates across product categories is important “to avoid negative consequences, such as product substitution or an increase in illicit trade”; equalized tax rates “should be accompanied by strong policies and measures against illicit trade in tobacco products.” The control of illicit trade is largely unrelated to the issue of comparable tax rates on different products.

Section 7 of the draft guidelines correctly notes that “[i]t is empirically proven that taxes and prices are not the main cause of illicit trade. Price is only one of the many factors that may influence illicit trade.”

#### **b) Use of revenues – financing of tobacco control**

There are strong opinions amongst Parties regarding the advisability and/or feasibility of so-called “dedicated taxes” on tobacco – that is, of legal provisions that require that a certain portion of tobacco tax revenue be spent on tobacco control (and, in some cases, on other public health purposes).

It is important to acknowledge that there are substantial differences in budget systems between Parties. For example, in some jurisdictions where budget issues can be decided by referendum, dedicated taxes are routine. In others, governments may legitimately believe that a law creating a “dedicated tax” would be unconstitutional. In between these two extremes, there is a wide range of practices. However, in jurisdictions where dedicated tobacco taxes have been used, the result has been very positive; it has allowed significant innovation in tobacco control, for example in the case of Thailand.<sup>2</sup> WHO has noted that quite a number of countries now have some form of dedicated tobacco tax.<sup>3</sup>

In FCA’s view, it should be possible to agree to a recommendation that Parties “should consider” using revenues from tobacco taxation, or a part thereof, to fund FCTC implementation. Considering a policy does not imply deciding to adopt it, but such a recommendation would send a signal that the positive experiences of Thailand and other Parties are worth a serious look.

#### **c) Simplify and clarify text with respect to tax-free/duty-free**

Article 6 of the FCTC commits Parties to “adopt or maintain, as appropriate, measures which may include... prohibiting or restricting, as appropriate, sales to and/or importations by international travellers of tax- and duty-free tobacco products.”

There are at least two arguments for eliminating duty-free sales of tobacco products.

First, duty-free products are comparatively cheap, and the entire purpose of Article 6 is to promote higher prices for tobacco products and thereby reduce consumption and prevalence. There is no possible public health argument for giving frequent travellers regular access to half-price cigarettes, for example.

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<sup>2</sup> “The Political Economy of Tobacco Taxation.” *WHO Technical Manual on Tobacco Tax Administration*. Geneva: WHO, 2010. 62-94.

<sup>3</sup> “The Political Economy of Tobacco Taxation.” *WHO Technical Manual on Tobacco Tax Administration*. Geneva: WHO, 2010. 62-94.

Second, the existence of a legal, duty-free market can and does provide a pretext for certain types of illicit trade, as shown by the frequency with which product marked “duty-free” shows up in informal markets in many countries. This does not necessarily mean that smugglers are purchasing cigarettes in duty-free shops; the diversion of duty-free product may happen much earlier in the supply chain, for example at the wholesale level, or at the factory gate.

The draft guidelines include several comments that are likely to create confusion on the issue of duty-free. For example, it refers to “tax- or duty-free shops at land borders” as being “the origin of illicit supplies of tax or duty-free cigarettes to final consumers,” and even suggests making a “distinction between the specificities of land, air and sea travel.” No evidence is presented for this distinction, and the draft appears to assume that leakage of tax-free product *at the retail level* is the primary problem with the duty-free marketing channel.

The recommendation at the end of section 6 refers to only half of the relevant text of FCTC Article 6 (i.e. “Parties should consider prohibiting or restricting the tax- or duty-free sales of tobacco products.”). It makes no mention of “restricting importations by international travellers of tax- and duty-free tobacco products”, and is thus weaker than the Convention itself.

Further, the recommendation appears to imply that tax- and duty-free sales are a concern only if a link with illicit trade is “ascertained”. This is inconsistent with FCTC Article 6, which includes no such qualifier, and at any rate illogical. As there is no benefit to duty-free sales of tobacco products, except to duty-free operators and tobacco companies, for which it is a significant promotional venue, Parties should consider banning it immediately, as a precautionary measure and so as to raise the average price of tobacco products, albeit modestly.

## Future Work

As with other guidelines, adoption of Article 6 guidelines should be the starting point for accelerated implementation of this article – not the end point.

FCA recommends that Parties consider a number of important elements of future work.

- **Alignment of FCTC reporting instrument with guidelines / improved reporting**

The existing reporting instrument for the FCTC<sup>4</sup> includes a number of questions that are relevant for Article 6 implementation, including on the supply of tobacco and tobacco products (2.5.1-2.5.3), seizures of illicit product (2.6.1-2.6.6), taxation (2.8.1-2.8.7), price of tobacco products (2.9.1-2.9.4) and price and tax measures to reduce the demand for tobacco (3.2.1.1-3.2.1.5).

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<sup>4</sup> See [http://www.who.int/fctc/reporting/reporting\\_instrument/en/index.html](http://www.who.int/fctc/reporting/reporting_instrument/en/index.html).

Upon adoption of the guidelines, Parties will likely wish to give some thought to ensuring the reporting instrument is well aligned with the guidelines. In particular:

- The draft guidelines emphasize the importance of monitoring and reducing the *affordability* of tobacco products. It would be helpful if Parties were specifically asked to report on affordability trends, although this might require some agreement on the type of indicator to use (such as percentage of GDP per capita needed to purchase 100 cigarettes);
  - A key recommendation in the draft guidelines (section 3.2) is that Parties should establish “coherent long-term policies on their tobacco taxation structure including targets for their tax rates”. This target can take several different forms, according to national circumstances. It would be helpful if the reporting instrument could specifically ask about Parties’ choice of policy approach and target;
  - In 2.9.1, price information is requested for “the three most widely sold brands of domestic and imported tobacco products at the most widely used point of sale in your capital city”. While any data is better than none, it is likely that many Parties, via their national statistical agencies, already collect much more accurate price data as part of regular surveys to determine their Consumer Price Index. Such Parties may be able to provide the *average* price of various types of tobacco products throughout the country.
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- **Data collection and data analysis**

One obstacle to optimal tobacco tax decisions is the lack of easily accessible, objectively analysed data about key features of the national market for tobacco products.

To give an example: the draft guidelines talk of the importance of “anti-forestalling measures” (in section 4.3). Forestalling refers to the widespread practice of stockpiling tobacco products, at the retail or wholesale level, in anticipation of a tobacco tax increase – particularly when tax increases are announced several months in advance. Detecting forestalling can be difficult, as there are legitimate reasons why levels of production (in the case of domestically manufactured products) and imports (in the case of foreign products) may fluctuate from month to month.

Governments that have no independent way to verify retail sales, or levels of stocks at different points in the supply chain, can be manipulated by the tobacco industry into believing that tobacco tax increases are having a bigger than expected impact on legal sales and will actually result in a loss of revenue.

There are many other examples in which reliance on unverified tobacco industry data is problematic for Article 6 implementation. This is an area where some form of export report could be very useful. The report could detail:

- The minimum data set that Parties need to take informed tobacco tax decisions (the “must haves”);
- Supplementary types of data that are useful (the “nice to haves”);
- Possible options for cost-effective collection of data;
- The types of data *analysis* needed for informed tobacco tax decisions (e.g. price elasticity estimates);

- Possible co-operative arrangements between Parties, or with relevant multilateral organizations, to collect and analyse relevant data (e.g. toolkits that could be prepared centrally).

- **Technical assistance and capacity building**

At COP5, Parties are likely to discuss technical assistance and capacity building arrangements for the entire spectrum of FCTC measures. Article 6 is somewhat unusual, however, in that the primary implementing agency in most Parties is likely to be the Ministry of Finance. This means that the task of developing and implementing a strong tobacco tax policy is substantially different from, say, drafting and enforcing tobacco control legislation that deals with smoke-free spaces (Art. 8), advertising, promotion and sponsorship (Art. 13) and labelling (Art. 11).

At present, a number of different multilateral agencies and non-governmental organizations provide valuable technical assistance on tobacco tax matters. However, if Parties are to accelerate implementation of Article 6, it is quite likely that the demand for technical assistance and capacity building will far outstrip supply.

It would be helpful if the COP, at its sixth session, had access to expert advice on:

- The nature of technical assistance needs (what type of skills/capacity is lacking at Party level);
- The magnitude of technical assistance needs (e.g. how many Parties are likely to need significant assistance in a given time period);
- Mechanisms for providing technical assistance (manuals, webinars, in-person workshops, expert missions, secondments, courses);
- Partners for technical assistance (relevant agencies or organizations and their specific niche or expertise).

## **Conclusion**

The adoption of Article 6 guidelines should be an important milestone in the implementation of the FCTC, as tobacco tax policy is a crucial but frequently neglected element of tobacco control.

The draft guidelines prepared by the Article 6 working group provide a solid basis for finalizing guidelines at COP5. FCA reminds Parties that the tobacco industry is strongly opposed to strong tobacco tax policies and will doubtless be lobbying some delegates to block adoption of the guidelines, or to water down their provisions beyond recognition.

FCA also recommends that Parties, in their decision adopting the guidelines, request some type of expert report or expert group to work on the related topics of data collection and analysis, improvements to the reporting instrument to reflect the new guidelines and technical assistance and capacity building.