Taxes on Tobacco

Excise taxes on tobacco products can raise fiscal revenues, improve health and well-being, and address market failures i.e. lost economic output from tobacco-related death and disease as well as the externalization of avoidable health costs for society to treat tobacco-related diseases.

Key Words: Tobacco; health; smart taxation; smart taxes; health finance; health financing

How does it work?

Tobacco excise taxes are taxes applicable on tobacco products, including "combustible" products such as cigarettes and "non-combustible" products such as chew. They can raise fiscal revenues, improve health and well-being, and address market failures—i.e. lost economic output from tobacco-related death and disease as well as the externalization of avoidable health costs for society to treat tobacco-related diseases.

Tobacco taxation is efficient because tobacco is relatively price elastic meaning that consumption will go down as prices go up and vice versa. When tobacco prices rise, people are less likely to start smoking, and current smokers are more likely to quit or to smoke less often. The definition of a uniform excise tax (tax based on quantity) is considered the best instrument. Other excises, such as ad valorem taxes (taxes based on value), may subvert the goal of reducing consumption by encouraging consumers to switch to cheaper brands, substitute one tobacco product for another that is taxed less, or switch categories of the same product (e.g. filtered versus unfiltered). Where countries incorporate an excise ad valorem system, introducing a specific excise tax floor can offset some of these risks.

Scientific evidence has proven that tobacco use drives poor health, namely cancers, cardiovascular disease (heart disease and strokes), diabetes and chronic lung diseases. Tobacco taxation is also proven to reduce tobacco use: a review of more than 100 international studies (http://tobaccocontrol.bmj.com/content/21/2/172.full) concluded that "Significant increases in tobacco taxes are a highly effective tobacco control strategy and lead to significant improvements in public health."

While there were concerns that tobacco taxes are regressive because the poor are more likely to smoke, these arguments fail to account for the tobacco-related disease burdens and associate costs borne by poor individuals and families due to their higher consumption patterns, and the particular price sensitivity of the poor. The poor are also more likely to live in environments which make the healthy choice the difficult choice, or constrain their access to health services. Tobacco taxes can help level the playing field. Because the poor are more sensitive to tobacco price increases, they are more likely to quit or reduce their consumption. As a result, their personal spending on tobacco is reduced and their health improved. Wealthier users, whose tobacco use typically declines less relative to price increases, wind up paying the majority share of the taxes. In Thailand, the Asian Development Bank estimates that 60 per cent of the deaths averted from a 50 per cent tobacco price increase would be in the poorest third of the population, who would pay just 6 per cent of the increased taxes. Moreover, revenue from tobacco taxes can be directed toward national social priorities, for example health promotion, early childhood education or social protection, and thus further increasing social spending.

Most countries tax tobacco products in some form. However, taxation at rates sufficiently high to reduce consumption is rare. The target from WHO's Global Tobacco Control Report (MPOWER) (http://apps.who.int/iris/bitstream/10665/178574/1/9789240694606_eng.pdf?ua=1&ua=1) is for tobacco taxes (excise plus others including sales taxes and import duties) to be 75 per cent of the retail price. In addition, taxes need to be increased on a regular basis to encompass inflation and income growth (i.e. to ensure that tobacco prices increase above income increases). Data from 2014 show that just 10 per cent of the world's population was covered by taxes (including excise) that total at least 75 percent of the retail price (http://apps.who.int/iris/bitstream/10665/178574/1/9789240694606_eng.pdf?ua=1&ua=1). Implementation in Low and Middle-Income Countries (LMICs), where it is needed most, is particularly lacking.

The main reason for low rate levels is the tobacco industry's interference in policymaking to halt tobacco tax reforms. In addition, there is limited understanding across government sectors of the economic gains——not just health benefits—to be had from tobacco taxes. Despite these challenges, public support for tobacco taxation is typically high (http://www.who.int/tobacco/surveillance/survey/gats/en/), even amongst smokers, and is even higher (http://www.iarc.fr/en/publications/pdfs-online/prev/handbook14/) when revenues from the tax are spent transparently and reinvested back into tobacco control and/or health more broadly.

The setting of the tax rate has implications for the amount of resources mobilized, in addition to altering consumption patterns. Evidence has shown that higher taxes will not decrease revenues. For example, between 1993 and 2009, South Africa increased total taxes on cigarettes (http://global.tobaccofreekids.org/files/pdfs/en/success_SoAfrica_en.pdf) from 32 per cent to 52 per cent of the retail price, experiencing sizable reductions in tobacco use and also a nine-fold increase in government tax revenues. Any misinformation or incomplete information provides the tobacco industry with an entry point to influence policy decisions. These closely linked challenges are a main impediment to tobacco tax reform.

Stakeholders

- **Government leaders:** Strong leadership is needed to promote effective tobacco taxation, and to ensure that ministries across government understand its importance for health and development.
- **Regulatory entity/ies**: Ministries of finance, tax administration and/or customs authorities can often implement tobacco taxation on their own, or the government authority responsible for tax revenues drafts the relevant bill for approval in the national/regional assembly. These ministries may work with other ministries (e.g. law, trade, interior) to ensure enforcement and regulation.
- **Revenue collection entity/ies**: The tax is collected by the tax administration and/or customs authorities, from importers, producers, wholesalers and/or retailers. The revenue might be transferred to the Treasury or allocated to a specified budget (e.g. health promotion programmes).
- **Payer**: Tax liability is typically borne by the manufacturers or importers, with costs transferred to the consumer through an increased retail price.
- **Wholesaler**: The wholesaler will transfer to the revenue authority the amount of tax, under a time-frame determined by the tax authority.
- **Tobacco industry and related business alliances:** the tobacco industry will resist attempts to improve public health through tobacco control. It should have no role in policymaking related to tobacco control, including in tobacco taxation. Tobacco growers and growers' associations should instead be included but only where measures have been taken to ensure that these stakeholders are not front-groups of the tobacco industry.

Potential in monetary terms (revenues, realignment or cost-savings)

Tobacco taxation can generate significant direct revenues as well as cost-savings through reduced health care costs and avoided economic productivity losses. In relation to the latter, for example, diabetes alone costs the world more than US$ 827 billion (http://apps.who.int/iris/bitstream/10665/204871/1/9789241565257_eng.pdf) in direct costs each year (tobacco increases the risk of Type 2 diabetes by 30-40 per cent (http://www.surgeongeneral.gov/library/reports/50-years-of-progress/full-report.pdf)). While the exact cost of tobacco to the global economy is unknown, the American Cancer Society and World Lung Foundation estimate it (http://3pk43x313ggr4cy0lh3tctjh.wpengine.netdna-cdn.com/wp-content/uploads/2015/03/TA5_2015_WEB.pdf) to be more than US$ 1 trillion per year.

Revenues from tobacco taxation vary across countries, depending on the tax rate applied, the number of products covered and the tax base. They can be significant. A recent study (http://www.who.int/bulletin/volumes/94/4/15-164707.pdf) published assessed the impact of raising excise on cigarettes in all countries by US$1 international dollar per pack (about US$0.8). This tax increase would see cigarette prices increase on average by 42 per cent globally, leading to as many as 66 million fewer smokers. The amount of cigarette excise revenue generated globally would increase by 47 per cent representing an extra US$141 billion in revenue. The Philippines (http://www.who.int/health_financing/topics/public-financial-management/D2-S4-JPaul-earmarking.pdf) generated US$3.9 billion in incremental revenues in the first three years of implementation of the Sin Tax Law (http://www.dof.gov.ph/index.php/advocacies/sin-tax-reform/), the bulk derived from tobacco taxes. In 2015, China increased its wholesale tax rate on cigarette (http://www.wpro.who.int/china/mediacentre/releases/2016/20160510/en/)s from 5 to 11 per cent. After one year, cigarette sales dropped by 3.3 per cent. This tax delivered an additional 70 billion yuan (US$11 billion) to the central government in one year.

When is it feasible?

Legal and/or other feasibility requirements

The World Health Organization (WHO) Framework Convention on Tobacco Control (http://www.who.int/fctc/en/) (WHO FCTC) is an international legally-binding treaty adopted by 181 Parties (November 2016). This means the Parties are legally obliged to implement its provisions, including price and tax measures to reduce the demand for tobacco (Article 6). The Sustainable Development Goals (SDGs), through target 3.a, commit all countries to strengthen implementation of the WHO FCTC (http://www.who.int/fctc/en/). The Addis Ababa Action Agenda (http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf) also recognizes that price and tax measures on tobacco can be an effective and important means to reduce tobacco consumption and health-care costs, and represent a revenue stream for financing for development. With tobacco taxation called for in Agenda 2030, implicitly through target 3.a, and within Paragraph 32 of the Addis Ababa Action Agenda, Member States now have three mutually reinforcing commitments to raise taxes on tobacco.

Specific requirements for raising tobacco taxes vary by country context and budgetary process and ultimately involve the amendment of the tax code or the passing of a law. The process is more expeditious where the ministry of finance, president or chief government executive has authority to determine the tax, and more complex where legislative or parliamentary approval is required. A larger number of actors is required in the latter scenario, making it particularly important to have strong leadership and broad-based coalitions in place. Strong implementation of Article 5 of the WHO FCTC (http://apps.who.int/iris/bitstream/10665/42811/1/9241591013.pdf?ua=1), which pertains to national planning, governance structures and reducing tobacco industry interference in policymaking, can facilitate implementation of tobacco taxation and other WHO FCTC provisions/articles.

Minimum investment required and running costs

Tobacco taxes are economically efficient and cost little to implement. A recent study (http://www.who.int/nmh/publications/cost_of_inaction/en/) estimated the cost of implementing and administering increases in tobacco tax to be US$0.05 per person per year in LMICs, positioning it as the least costly of all tobacco control policies. Independent analysts have classified tobacco tax increases as a “phenomenal” intervention (http://www.copenhagenconsensus.com/sites/default/files/owg12.cost-benefit-assessment_0.pdf), with robust evidence for benefits more than 15 times the costs to implement.

Additional costs might be incurred for financing advocacy and awareness-raising campaigns to address common misconceptions amongst policymakers and the general public, including those promulgated by the tobacco industry.

In what context/when it is more appropriate

Tobacco taxes are appropriate in all settings where tobacco products are produced or sold. However, the political feasibility of raising tobacco taxes varies between countries and may be particularly challenging in countries where the Government owns or manages the tobacco industry. Such a scenario underscores the need for strong advocacy on why raised tobacco taxation benefits not just public health but also priorities spanning different government sectors, including economic growth, education, gender, and social welfare. UNDP has developed a non-communicable diseases (NCDs) specific Institutional and Context Assessment tool that can support tobacco taxation efforts.

What are the main risks and challenges?

Pros

- Reduces health inequities and advances sustainable development.
- Reduces health care costs and productivity losses due to tobacco-related diseases.
- It addresses market failures, i.e. the internalization of related health system costs.
- Fairly easy to implement with very limited sunk costs.
- Support and guidance are available.

Cons

- There are virtually no negative consequences due to the taxation of tobacco products. However risks emerge where tax systems are poor or where steps are not taken to support farmers to transition to alternative livelihoods.

Risks

- Coordination failures: governance challenges including siloed and un-coordinated responses, policy incoherence, and intra-governmental conflicts.
- Tobacco industry interference is the main risk to overcome in introducing or reforming tobacco taxation.
- Tax evasion (e.g. under declaration of value/volume, corruption of tax inspectors, etc.). Illicit trade can be frequent, especially smuggling from low to high-taxed jurisdictions; even where illicit trade does occur, tobacco tax increases still lead to higher tax revenues for government and reduced consumption (http://apps.who.int/iris/bitstream/10665/178574/1/9789240694606_eng.pdf?ua=1&ua=1).
- High rates of inflation could reduce the real value of specific excise taxes or economic growth may result in incomes growing more rapidly than tobacco taxes and prices, making tobacco more affordable and rendering the taxes less effective.
- Forestalling (e.g. actors along the supply chain stockpile products before the tax takes effect).
- While the expected reaction would be a shift from tobacco to other forms of consumption such as nutrition, an opposite income effect is still possible considering the addictive nature of tobacco products.

How can the design be ameliorated to improve the impact?

Tobacco use kills an estimated six million people each year (http://www.who.int/mediacentre/factsheets/fs339/en/) globally and accounts for approximately one in six deaths from cancer, diabetes, heart disease and other NCDs. Nearly 75 per cent of NCD deaths, and 82 per cent of those before the age of 70, occur in LMICs. LMICs have lower capacities to respond and must contend simultaneously with ongoing infectious disease burdens. Tobacco use has been implicated in these challenges, too. It increases risk for tuberculosis, and worsens outcomes for people living with tuberculosis and/or HIV. Tobacco use, if unabated, is projected to cost one billion people their lives in the 21st century, most in LMICs, while costing the world economy trillions of dollars in medical expenses and lost productivity. Out-of-pocket medical expenses force individuals to liquidate income-generating assets to pay fees, or to forgo care entirely. Unpaid care work rises for women and young girls, with the latter pulled out of school to care for sick or disabled relatives. Given the multiple pathways through which tobacco consumption impedes sustainable development, it follows that tobacco taxation—scientifically proven to reduce tobacco consumption—would deliver wider benefits to sustainable development (http://www.fctc.org/fca-news/opinion-pieces/1299-new-report-tobacco-a-barrier-to-sustainable-development), for example poverty and inequality reductions.

In fact, a double dividend from tobacco taxation can be achieved where the mobilized revenue is invested into social and environmental spending, including on the provision of universal health coverage. Adverse economic impacts of tobacco taxation on tobacco workers, if any, can be reduced by providing economic and non-economic incentives for the most vulnerable populations, for example incentives for shifting farming practices into sustainable agricultural commodities. The Philippines earmarks about 15 per cent of incremental revenue collected from tobacco taxes in the Sin Tax Law (http://www.dof.gov.ph/index.php/advocacies/sin-tax-reform/) to support alternative livelihoods for tobacco farmers and workers in tobacco growing provinces, in line with Articles 17 and 18 of the WHO FCTC (http://apps.who.int/iris/bitstream/10665/42811/1/9241591013.pdf?ua=1). The remaining and vast majority portion of incremental revenue is used as a source of sustainable financing for the country's Universal Health Care Programme.

Governments should consider a number of design elements when seeking to maximize the social and environmental benefits of tobacco taxation:

- *Good governance framework.* Article 5.2(a) of the WHO FCTC (http://www.who.int/fctc/implementation/cooperation/project-Article-5.2-A-National-coordinating-mechanism/en/) obliges Parties to establish a governance framework, or leverage an existing one, that can coordinate the complexities of tobacco control interventions, such as tobacco taxation, while facilitating action across sectors. Article 5.3 requires Parties to protect their tobacco control efforts from industry interference.
- *Tax structures*. Uniform specific excise taxes are considered the best practice. Uniform specific systems are the easiest and least costly to administer, but also bring about the best health and fiscal outcomes. Ad valorem systems should use a well-defined base of calculation or a specific floor.
- *Continuous monitoring.* Governments should stay abreast of economic considerations that affect price elasticity of demand, changes in inflation and household income levels, to ensure that tobacco taxation continues to achieve its objectives. Article 6 Guidelines for Implementation (http://www.who.int/fctc/guidelines/adopted/Guidelines_article_6.pdf) call for regular monitoring and adjustment processes of a country's tax policy, to avoid the types of situations experienced recently in Bangladesh (http://www.itcproject.org/node/144), where the price of tobacco products increased between 2009 and 2015 but rapid economic growth more than offset these increases, keeping the tobacco products highly affordable. Tying tobacco tax levels to nominal wages, as Australia has done (http://www.fctc.org/media-and-publications/reports/price-and-tax/1251-fctc-guidelines-on-tobacco-tax-what-advocates-should-know), or other broad measures of income, can both help keep tobacco taxation levels in line with economic developments to ensure tobacco products become less affordable over time (with the latter strategy especially useful in countries where good data on wage levels is lacking).
- *Administration.* Effective and efficient tax administration is key to avoid evasion, and to offset risks such as tax avoidance, tax evasion and forestalling (http://www.fctc.org/media-and-publications/reports/price-and-tax/1251-fctc-guidelines-on-tobacco-tax-what-advocates-should-know). Simple tax structures make tax administration easier. Article 6 Guidelines for Implementation recommend that: "In order to reduce the complexity of tax collection systems, excise taxes should be imposed at the point of manufacture, importation or release for consumption from the storage or production warehouses (http://www.who.int/fctc/guidelines/adopted/Guidelines_article_6.pdf)." This is largely because waiting until consumers buy the cigarettes or other products from the retailers makes taxes much harder to track. Other underlying principles of effective tax administration are to have a clear designation of responsible enforcement authorities, information sharing amongst enforcement agencies, and strict enough penalties to deter noncompliance. Addressing loopholes such as duty free shops is also important.
- *Complementary tobacco control measures*. Tobacco taxation works best when implemented alongside other WHO FCTC (http://apps.who.int/iris/bitstream/10665/42811/1/9241591013.pdf?ua=1) measures, particularly the protocol to eliminate illicit trade in tobacco products and Article 5 on tobacco control governance. Strengthened multi-sectoral governance for tobacco control allows government ministries to come together and agree optimal taxation approaches, while firewalling vested tobacco industry interests from policymaking. Several other WHO FCTC (http://apps.who.int/iris/bitstream/10665/42811/1/9241591013.pdf?ua=1) measures are synergistic with tobacco taxation, including bans on price-reducing marketing strategies (e.g. promotions such as coupons and multipack deals), educational campaigns and cessation support.

Use of revenue and political capital. Guidelines for Article 6 Implementation (http://www.who.int/fctc/guidelines/adopted/Guidelines_article_6.pdf) are non-prescriptive in how Parties should spend tobacco tax revenues, as is the Addis Ababa Action Agenda. However, Article 26.2 of the WHO FCTC (http://apps.who.int/iris/bitstream/10665/42811/1/9241591013.pdf?ua=1) notes the potential for tobacco taxation to finance specific tobacco control policies. Respective guidelines for implementation of Articles 8, 9, 10, 12 and 14 all note the same. Indeed, public support for raised tobacco taxes tends to be highest where the money is reinvested into tobacco control or to finance health promotion more broadly. Framing tobacco taxation as contributing to other priorities, such as reducing the impact of tuberculosis, supporting economic growth or investing in early childhood education, can further bolster political and social acceptance.

Guidelines and Case Studies

Guidance

- Guidelines for implementation of Article 6 of the WHO FCTC (http://www.who.int/fctc/guidelines/adopted/Guidelines_article_6.pdf)
- FCTC guidelines on tobacco tax: what advocates should know (http://www.fctc.org/media-and-publications/reports/price-and-tax/1251-fctc-guidelines-on-tobacco-tax-what-advocates-should-know)
- WHO technical manual on tobacco tax administration (http://www.who.int/tobacco/publications/economics/tax_administration/en/)
- WHO global report on the global tobacco epidemic, 2015 (http://www.who.int/tobacco/global_report/2015/en/)
- Raising taxes on tobacco: what you need to know (http://apps.who.int/iris/bitstream/10665/112841/1/WHO_NMH_PND_14.2_eng.pdf)
- Tobacco taxes as a tobacco control strategy (http://tobaccocontrol.bmj.com/content/21/2/172.full)
- Earmarked tobacco taxes: lessons learnt from nine countries (http://apps.who.int/iris/bitstream/10665/206007/1/9789241510424_eng.pdf)

Case studies

- Philippines (http://www.globalhealthdelivery.org/blog/2015/12/new-case-study-the-philippines-battle-for-tobacco-tax-reform/)
- *See* WHO technical manual on tobacco tax administration (http://www.who.int/tobacco/publications/economics/tax_administration/en/)
- *See* Campaign for tobacco free kids – resources on tobacco and price (http://global.tobaccofreekids.org/en/resources/by_issue/taxation_price/)

Our work

» (/content/rbap/en/home/post-2015/sdg-overview)

(http://www.undp.org/content/home/en/home/post-2015/)

Environmental finance » (/content/undp/en/home/ourwork/sustainable-development/natural-capital-and-the-environment/environmental-finance/)

Our Perspective (/content/undp/en/home/blog/2015/7/9/The-macreconomics-of-development-financing-/)

Jul 9, 2015
We should reach a consensus on the fact that macroeconomic policies in low-income economies need to also jettison the conventional wisdom of undue restrictiveness.