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Privatization in the Tobacco Industry:
Issues and Good Practice Guidelines to Ensure Economic Benefits and Safeguard Public Health

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Privatization in the tobacco industry raises fiscal policy and public health concerns, that IMF and World Bank staff need to consider in policy discussions and privatization conditionality. This note sets out key issues and guidelines.

Objectives of this note

- To share lessons learnt on privatization of tobacco companies in developing countries
- To provide good practice guidelines for IMF and Bank staff, pre- and post privatization of tobacco companies, so as to reap the intended economic benefits while safeguarding public health.

Introduction – what differentiates *tobacco* privatization?

Many developing countries have privatized state-owned tobacco companies as part of broad adjustment programs to address severe macroeconomic problems, transform economies and promote efficiency and economic growth. When privatization of tobacco companies is considered to be desirable, the implications for public health need to be addressed, and "good practice" guidelines should be followed, especially with regard to an appropriate regulatory framework.

Lessons learnt in privatizing tobacco industries in developing countries

(1) Privatization is often followed by increased output. Increased consumption of tobacco products has serious public health implications.

Privatization in the tobacco industry raises special concerns for public health and should not be treated like any other state-owned industry privatization. Privatization is usually expected to improve productivity and efficiency, which may imply lower-priced products, higher sales and increased production. Reviews of privatized industries find that this is often achieved.[1]

If privatization leads to higher consumption of tobacco products, tobacco-related deaths and disease will increase in future, with associated economic and development costs.[2] To counter this, proven measures are needed to discourage tobacco use as part of the appropriate regulatory framework for the industry (see below).

(2) Appropriate regulatory measures should be in place prior to tobacco sector privatization. These include proven effective, comprehensive tobacco control measures to safeguard non-smokers and youth and to inform smokers adequately.

Just as with privatization in other industries, **it is important to ensure that an appropriate regulatory environment is in place, ideally, before privatization**. This sets the "rules of the game", enables potential purchasers to assess more accurately the value of the enterprise and price they are willing to pay, and safeguards public health.

In the case of tobacco products, an appropriate regulatory environment includes measures to: adequately inform citizens of the health risks of tobacco use and benefits of quitting; protect children, youth and other non-smokers from being enticed or misled into using highly addictive products; and protect people from the harm caused by inhaling "second hand" smoke, at least in public places.

Tobacco product consumption and the resulting negative health effects can be reduced by these effective and proven measures:[3]

- higher real prices through regular tobacco excise tax increases,
- bans on all tobacco advertising and promotion,

[1] There are numerous reviews of performance of privatized firms. See, for example, Kikeri and Nellis 2001. Few studies look specifically at performance of privatized tobacco companies. Krasovsky et al 2002 compare the performance of state-owned cigarette companies in Ukraine with companies in which private sector multinationals first established joint ventures, and then increased their ownership share to 100% in some cases. Onder (2002) provides data comparing performance of private and state-owned cigarette producers in Turkey.

[2] Tobacco causes over 30 serious diseases, often fatal or chronic and disabling. One quarter of all long-term users die during their productive years. "Second hand" cigarette smoke also causes lung and heart disease in non-smokers. The productivity and income losses, health care costs, and consequences for poverty, are significant. The links between tobacco consumption and health outcomes are well-documented in thousands of studies. A succinct summary can be found in World Bank, 1999. See also various US Surgeon General's reports.

[3] World Bank 1999 reviews and summarizes the empirical evidence on effectiveness (and cost-effectiveness) of policies to discourage tobacco use.

- bans on smoking in public and work places ("smoke free" policies),
- help for smokers who wish to quit, and
- information on the risks of tobacco use and benefits of quitting, including large, clear warnings on product packages in local languages, preferably with pictures, especially where illiteracy is widespread.

These measures are reflected in the key provisions of the Framework Convention on Tobacco Control (FCTC), which entered into force on February 27, 2005, with 58 countries already having ratified (or equivalent).[4] The FCTC had been unanimously adopted by 192 WHO member states at the World Health Assembly in May 2003, and was signed by 168 entities, including the European Community. This first international treaty on a health topic sets out the broad international, evidence-based consensus on the key recommended policy measures for reducing tobacco use, an important factor in improving health outcomes.

(3) In countries that have privatized without a good regulatory framework in place, it is better to put it in place later than not at all. However, it may be harder to do after privatization, because of cigarette companies' opposition to effective policy measures to discourage tobacco use.

Agreements reached during privatization negotiations (see point 4 below); concern not to alienate foreign investors; or successful efforts by companies to influence government officials can make governments less willing or politically able to implement tobacco control measures -- especially tax increases -- after privatization. In many countries, private sector cigarette companies have lobbied strenuously against tobacco control measures, especially tobacco tax increases, restrictions on advertising and promotion, and "clean air" policies in workplaces and other public spaces, designed to protect non-smokers and discourage smoking.[5]

The Bank could do more to encourage <u>"remedial action" in countries that have privatized without putting in place an appropriate regulatory framework</u>, through analytic work and policy dialogue, and loan/credit financial support and conditionality. The Healthpop Advisory Service can help link task teams with the WHO Tobacco Free Initiative, specialist NGOs and international experts who can provide technical expertise on developing and implementing effective tobacco control policies.

(4) "Side deals" or conditions in privatization agreements can undermine fiscal policy and national and international efforts to reduce tobacco product consumption. Special advantages granted to tobacco industry investors may jeopardize the expected benefits of privatization.[6] When the World Bank and/or IMF require governments to privatize tobacco companies, staff need to be as concerned about the process and conditions of the transactions as in privatization of utilities. Governments should be advised to <u>avoid extended profit tax holidays</u>, a common incentive for foreign investors, which can involve very large amounts of foregone revenue for governments.

Privatization agreements are often reached without adequate transparency. This has made it easier for international tobacco companies that have purchased state-owned cigarette enterprises to win significant concessions from governments, concessions that reduce the benefits for development and damage public health outcomes. For example, there were exemptions from profit taxes for 5-10 years in Kyrgyz Republic, Hungary and Ukraine. The government of Kyrgyz Republic agreed to discuss tax adjustments with the tobacco company before making changes, and also guaranteed the company that it would be the sole producer in the country, effectively replacing the state monopoly with a private monopoly. In Moldova, a Bank mission got the impression that government officials were afraid that multinationals interested in buying the state industry wanted to close it down to eliminate it as a competitor to their other companies in the region, and that the government might be willing to offer concessions to the buyer in exchange for assurances that the domestic industry would continue to operate.

The Bank and the IMF should continue to urge/require governments to <u>make tobacco privatization processes and agreements transparent</u>. An independent third party could help manage and negotiate a fair privatization deal, enhance transparency and reduce the risk of side-deals and agreements that run against the public interest.

(5) The government's inherent conflict of interest (between the profit/performance of state-owned tobacco companies and government's public health responsibilities) does not go away entirely when governments sell tobacco companies to private investors. The balance of effort in striving to increase sales and to decrease consumption is likely to shift.

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[4] Details on the FCTC are available at www.who.int/tobacco/en

[5] Efforts by tobacco companies to lobby against regulations and policies that would reduce tobacco use are well documented. For example, see Szilagyi et al. 2003 for an account of events in Hungary; six country case studies in de Beyer and Waverley Brigden (eds) 2003; Report of the Committee of Experts on Tobacco Industry Documents 2002; Campaign for Tobacco-Free Kids and Action on Smoking and Health-UK 2001; and Hastings and MacFadyen 2000.

[6] This is not unique to privatization in the tobacco industry. But as noted in point (3) above, tobacco companies have been particularly assiduous in lobbying against regulatory measures that are likely to reduce sales.

Governments that own and control cigarette companies must balance a conflict of interest between company profits/revenues, and efforts to reduce use of tobacco products to improve health. One could regard the typical situation as an (implicit or explicit?) compromise: state-owned companies put minimal resources and effort into advertising and marketing cigarettes[7], and the government implements some policies and measures to deter smoking.

After privatization or entry of private sector producers, advertising and marketing typically become much more aggressive and effective, and often target youth and women, to compete for existing market share and to recruit the new smokers on whom the industry's long term profits depend. This drives sales up, sometimes dramatically, as happened in Turkey after 1993. Since the government still generates excise and profit tax revenue from tobacco companies, many governments remain ambivalent about wanting to maintain tobacco tax revenues and wanting to reduce the negative health impact of tobacco use. But once the tobacco industry is in highly professional hands, the government needs to raise its level of professionalism in regulating the industry. Bank and IMF economists who work on tobacco privatization need to be as concerned about the government's ability to regulate as economists who work on telecommunications privatization must be about creating a regulatory and policy function within the government.

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[7] Although a national monopoly has no need to advertise to compete for market share (except against imports), they could have an incentive to advertise to increase sales, if they have constant or declining unit production costs and hence higher profits as sales rise.

Annex I

Countries where tobacco privatization is, soon will be, or has recently been on the agenda, and status, and other countries with substantial state ownership.

Country	**Status**
Bulgaria	Privatization has been on and off the government's agenda. It is a sensitive issue given that the country's Turkish minority is heavily represented in the tobacco sector. In December 2002 the Bulgarian Supreme Administrative Court upheld its cancellation of a deal to sell the tobacco monopoly (Bulgartabak) to a Deutsche Bank-backed consortium and ordered all bidders in the original tender to submit improved bids. In October 2003, the government approved a new strategy for Bulgartabac privatization: piecemeal sale of the 9 cigarette production companies and 12 tobacco processing subsidiaries. In February 2005 BAT withdrew a £138 million offer for three of the company's factories following opposition to the sale in Parliament and the ruling party coalition over potential job losses.
China **(privatization is not on the agenda)**	Cigarettes are the last remaining large state monopoly in China. STMA accounts for nearly one third of global cigarette production, almost all for domestic use. Tobacco contributes about 8% of total central government revenues, and considerable parts of the revenue of some provincial and local authorities. High tariff barriers on imports are being dismantled under WTO, but new non-price barriers are being introduced. Some very limited joint ventures have been undertaken with multinationals, who are very eager to compete for the huge Chinese cigarette market. In April 2005 it was reported that Philip Morris had reached a licensing agreement under which its Marlboro brand would be manufactured and sold in China. Imperial and Gallaher have signed similar agreements. Despite these deals, the government has reiterated its opposition to direct investment by foreign cigarette companies.
Iran	In 2002, the Iranian Tobacco Company (ITC) finalized a series of multi-million dollar agreements with Reemtsma, BAT, JTI and South Korea's Tobacco and Ginseng Company allowing their products to be imported and locally produced. In 2003, Iran's parliament refused to privatize ITC. In April 2005, ITC's Director General and his deputy were arrested on suspicion of embezzling money and taking bribes.
Egypt	The government controls a majority interest in Eastern Tobacco Company. Plans to privatize the company were dropped in 2001. However Eastern continues to enter into joint venture agreements with foreign companies such as Philip Morris and BAT to produce their international brands in Egypt.
Macedonia	Some privatization has been done in line with IMF requests that the tobacco sector be liberalized. There are still 2 cigarette factories -- Prilep and Kumanovo -- that have been due for privatisation for several years, attracting interest from BAT and Philip Morris. In 1994 and 1995 tobacco processing plants were acquired by companies from Greece (ATCAE) and The Netherlands (Intabet). The Skopje cigarette factory was sold to Reemtsma, via its Slovenian based subsidiary in 1999.
Moldova	In July 2001 Parliament approved placing the tobacco monopoly on a list of enterprises to be privatized but this is currently on hold.
Morocco	In 2003 the government sold an 80% stake in Regie Des Tabacs to Altadis for $1.53 billion.
Romania	Following a failed privatization effort in 2001 it was announced in January 2004 that a majority stake in Societatea Nationala Tutunul Romanesc SA (SNTR) had been sold to a consortium which included an energy company registered in the Virgin Islands and an Italian tobacco processor. However questions about the lawfulness of the sale and the legal status of SNTR's landholdings led the government to hire PriceWaterhouse Coppers to perform an audit of the sale in June 2004. Whatever the result of the investigation, it is uncertain whether SNTR will be able to re-establish reasonable market share in the face of well established production in Romania by BAT, PM and RJ Reynolds and the considerable illegal trade.
Serbia	In February 2003, the Serbian Parliament adopted legislation paving the way for the sale of the tobacco plants, stipulating that no single company could buy both. Bids were made in July 2003. Philip Morris's offer of €387 million for a 66.45 percent stake in Duvanska Industrija Nis (DIN), the largest and most profitable, was accepted, as was BAT's sole offer of €50 million for a 67.81 percent stake in Duvanska Industrija Vranje (DIV).
Taiwan	It is expected that privatization of the Taiwan Tobacco & Liquor Corporation, which had been delayed due to union protests, will take place some time in 2005.
Thailand	Steps to privatize were stopped by the parliament in 2003 and privatization is unlikely in the near future.
Turkey	Two unsuccessful attempts were made to privatize Tekel. In November 2003 the government cancelled a proposed sale because final bids were considered to be below the company's value, and in April 2005 there were no bids.

Sources: Information drawn from numerous press reports and company annual reports.

Annex 2: Tobacco Company Ownership and Production Levels (millions of cigarettes), by Country

State Owned (mostly or fully)		Predominantly private ownership or joint ventures				No Information available on ownership	
	Production		Production		Production		Production
China	1701000	US	576700	New Zeal.	6300	Algeria	21500
Japan	256200	Russia	374000	Israel	6150	Iraq	14200
Turkey	128350	Indonesia	230000	Sweden	5700	Bosnia & Hercegov.	8600
S. Korea	97700	Germany	213793	Sri Lanka	5500	Syria	8200
Egypt	47500	UK	126141	Cameroon	5250	Macau	7000
Italy	44726	Netherlands	123675	Cyprus	5100	DR Congo	5300
Romania	34500	Brazil	109400	Cote d'Ivoire	4750	Libya	3500
Thailand	30500	India	94000	Ecuador	4700	Ethiopia	2500
Vietnam	30000	Poland	76570	Turkmenist.	4600	Myanmar	1550
Bulgaria	25600	Philipp.	73000	Cambodia	4300	Burundi	1360
Taiwan	22226	Ukraine	67000	Lebanon	4250	Laos	1300
Iran	16200	Spain	63100	Tanzania	4250	Haiti	880
Cuba	16000	Pakistan	58075	Macedonia	4200		
N.Korea	15500	Canada	50000	Peru	4200		
		Mexico	47200	Jordan	4100		
Moldova	9600	Argentina	42500	Finland	4000		
Yemen	4900	France	37730	Uruguay	3900		
Azerbaijan	3250	Switzer.	37550	Guatemala	3900		
		Greece	36300	Lithuania	3800		
		Czech	31500	Zimbabwe	3800		
		Australia	29500	Slovenia	3700		
		Malaysia	28450	Armenia	3600		
		S. Africa	27802	Senegal	3400		
		Venezuela	27000	Dom.Rep.	3388		
		Kazakhstan	26700	Kyrg. Rep.	3100		
		Austria	25360	Latvia	3000		
		Portugal	21300	Angola	2500		
		Hungary	20800	Madagascar	2500		
		Belg-Lux	18100	Nicaragua	2400		
		Bangladesh	15000	Ghana	2250		
		Croatia	14000	Honduras	2247		
		Singapore	12875	Costa Rica	2025		
		Morocco	12800	Paraguay	1950		
		Denmark	12700	Norway	1765		
		Chile	12640	El Salvador	1620		
		Colombia	12040	Estonia	1600		
		Belarus	12000	Malta	1600		
		Slovak Rep.	11500	Zambia	1600		
		HK	11136	Nepal	1500		
		Nigeria	10200	Mauritius	1500		
		Uzbekistan	10000	Bolivia	1300		
		Tunisia	9200	Trin.&Tob.	1300		
		Ireland	7900	Jamaica	1280		
		Kenya	7500	Sierra Leo.	1225		
		Georgia	7400	Mozambiq.	1200		
		Albania	7250	Congo	1040		
		Tajikistan	6400	Malawi	850		

Sources: USDA attaché reports, Company Reports, Ross Hammond, Market file database