Knowledge Brief

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TEN PRINCIPLES OF EFFECTIVE TOBACCO TAX POLICY

Caryn Bredenkamp, Roberto Magno Iglesias and Kai-Alexander Kaiser

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KEY MESSAGES

- When proposing reforms, tobacco taxes need to be presented not only as revenue measures, but also as in the public's best interest.
- A unitary specific rate is best – for tax administration, for revenues, and for health – and should be regularly adjusted to avoid the erosion of real revenues by inflation.
- Implementation needs to be accompanied by revenue protection and anti-smuggling measures, including tax stamps.
- Reliable data and good analysis matters. Before undertaking reform, solid market analysis using non-industry data will help to optimize tax design, while after the reform, continuous monitoring of market prices and tax stamp roll-out will help protect it.

Public Disclosure Authorized

Introduction

This brief provides guidance in the design of effective tobacco tax policies in countries such as the emerging ASEAN economies, where tax administration and enforcement capacity may not be as strong as in OECD countries. It focuses on tobacco, but many of the principles are equally applicable to other excise taxes, such as alcohol. While bearing in mind that policy advice should always be tailored to context, these principles have wide applicability across countries. The brief is illustrated with examples from the 2012 Philippines tobacco and alcohol "sin tax" reform and draws on the experience of World Bank teams in providing technical assistance to tobacco tax reforms in the Philippines, Vietnam and Indonesia.

The Ten Principles

1. **When proposing reforms to tax rates and structure, tobacco taxes need to be presented not only as revenue measures, but also as in the public's best interest.** In general, the public is resistant to tax increases, and especially so when they lack confidence in the government's ability to spend the revenues well. Therefore, Ministries of Finance need to highlight not only the revenue increases, but also what the public will gain from the tax. In the Philippines, the strategy was to stress the health gains of the tobacco and alcohol excise taxes, emphasizing the lives that would be saved from reduced smoking, as well as to link revenues to priority areas of expenditure, specifically universal health coverage. Political economy and stakeholder analyses will help to determine which priorities and arguments would be most powerful in a given context.

2. **Increases in tax rates should be large and sustained enough to reduce consumption.** Small and episodic increases in tax rates are unlikely to reduce consumption because demand for cigarettes is quite inelastic. People need relatively large price shocks, as well as the prospect of relatively large future price increases, in order to reduce consumption.

3. ***An ad valorem* tax structure should be avoided.** In lower and middle-income country contexts, with relatively weak tax administrations, *ad valorem* is easily abused because it requires calculating and declaring the exact tax base (valuation) of every brand on the market. By contrast, specific taxes require verification only of the quantity sold.

4. **A unitary specific rate (i.e., no tiers) is best – for tax administration, for revenues, and for health.** Unitary rates mean that tax authorities need only count the number of cigarettes manufactured in order to determine the tax to be paid. It also prevents the tobacco industry from gaming the system by down-shifting, i.e. pricing cigarettes in the lower tiers in order to avoid the higher rates in the upper tiers and to maintain consumption among price-sensitive consumers. A unitary rate also makes sense from a health perspective: because every cigarette is equally harmful, every cigarette should be taxed equally.

5. **Multiple tiers should only be used temporarily for transition to a unitary rate, and transitions should be kept short and tiers few.** If multiple tiers are necessary as an interim measure during transition to unitary, it is important to ensure that the transition period is short (for example, < 3 years) and the number of tiers are very few (for example, 2 tiers). The Philippines is in transition to a unitary tax on tobacco over five years, but went immediately to as few as two tiers in the first year of implementation (i.e., 2013).

6. **Specific rates should be automatically adjusted for inflation to avoid erosion of real revenues and to maintain the incentive to reduce smoking (i.e. to protect health**). Tax reforms and laws should include provisions that index (specific) tax rates to inflation. If not, then the real revenues obtained from taxes will be eroded over time. Also, the health impacts of taxation would be weakened as tobacco products become cheaper relative to incomes, inducing a return of consumption. In the Philippines, for example, lack of indexation contributed to the near-halving of tobacco and alcohol tax revenues from 1999 to 2011, during which time revenues fell from 0.9 percent of GDP in 1999 to 0.5 percent of GDP in 2011.

7. **Grandfathering or special cut-off dates, which protect incumbent producers and manufacturers, should be avoided at all costs**. When incumbent producers/manufacturers are offered exemptions or discounts from tax increases, it introduces many distortions which undermine both the revenue and health effects. It creates an uneven playing field for producers, creates a barrier to new market entrants, and reduces overall revenues. Also, by making existing tobacco products cheaper than similar new products, it severely blunts the health impact of the reform.

8. **Implementation of taxes needs to be accompanied by revenue protection and anti-smuggling measures, including tax stamps, unique identifiers, and law enforcement**. To ensure that all cigarettes entering the market (whether from domestic or cross-border sources) have paid the tax that is due, tax stamps and/or unique identification markings (for example, serial numbers or local language warning labels) are recommended. Additional measures could include the use of camera surveillance, production control tools or on-site tax inspectors at manufacturing plants and warehouses. Increased law enforcement would be an important complementary measure.

9. **To optimize tax design – and health and revenue impacts – good market analysis should be done before undertaking tax reform.** Important basic data include the market share of different products, production costs, prices and current government revenues. This can be used to simulate scenarios of consumer and producer responses to different tax rates, and the corresponding health and revenue impacts. Government agencies should have their own independent and reliable sources of data to avoid having to rely on data collected by the tobacco industry.

10. **Post-reform, continuous monitoring of market prices and tax stamp roll-out will help to validate whether taxes are being paid and passed on to consumers in the form of price increases.** Regular price data and stamp data, collected through internal revenue offices, can be complemented by innovative bottom-up data collection through mobile app-based platforms with data transmitted by consumers.

This HNP Knowledge Brief was prepared by Caryn Bredenkamp, Roberto Magno Iglesias and Kai-Alexander Kaiser (World Bank). It draws on the experience of World Bank teams in providing technical assistance to tobacco tax reform in the Philippines, Vietnam and Indonesia. It has benefitted from comments provided by Kari Hurt, Tuan Minh Le, Yue Man Lee and Patricio Marquez (World Bank), Mark Goodchild (WHO), and Jeremias Paul (Department of Finance, Philippines).

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