

CHAPTER V

Best practices

THIS CHAPTER describes best practices for tobacco tax policy, emphasizing the public health impact of tobacco taxes while also recognizing the importance of the revenues generated by the taxes. Based on the accumulated empirical evidence and published literature described above, these best practices represent a roadmap that most countries can readily implement. For many countries, the best practices described here will be considerably different than current tobacco tax practices and will require a transition strategy. Where relevant, the best practices described below include some discussion about effective transition strategies.

Use tobacco excise tax increases to achieve the public health goal of reducing the death and disease caused by tobacco use

Extensive economic and other research has clearly demonstrated the effectiveness of higher tobacco product taxes and prices in reducing tobacco use and its consequences, particularly among the poor and the young. At the same time, tobacco excise tax increases will generate sizable new revenues that will be sustained in the short to medium term. In the long run, continued increases in tobacco taxes coupled with implementation of other evidence-based tobacco control policies and programmes will lead to even larger reductions in tobacco use and its consequences and, eventually, to declining tax revenues.

Set tobacco excise tax levels so that they account for at least 70 percent of the retail prices for tobacco products

Tobacco excise taxes (or other taxes uniquely applied to tobacco products) in nearly all countries account for less than 70 percent of retail prices, with taxes in most accounting for less than half of retail prices. Raising tobacco taxes so that they account for at least 70 percent of retail prices would lead to significant price increases, induce many current users to quit, and deter numerous youth from taking up tobacco use, leading to large reductions in the death and disease caused by tobacco use. At the same time, such tax increases will generate significant increases in tobacco tax revenues. It is important to note that this best practice focuses on tobacco excise taxes (or other tobacco-specific taxes) and not on all taxes applied to tobacco products, given that these are the taxes that lead to increases in the prices of tobacco products relative to the prices of other goods and services and, consequently, to reductions in tobacco use. In countries that have already reached this threshold, further increases in tobacco taxes in line with other practices described below would be appropriate.

Simpler is better

Complex tax structures are more difficult to administer, create more opportunities for tax avoidance and evasion, and are less effective in achieving public health and revenue goals. Simplifying the structure of tobacco excise taxes will ease tax administration, reduce tax avoidance and evasion and enhance revenues, and have a greater impact on tobacco use by reducing incentives to substitute among tobacco products/brands in response to tax increases. In countries with complex tax structures, an appropriate transition strategy involves reducing the variations in taxes over time with the aim of implementing a single uniform tax on a given tobacco product. Countries with multiple tiers based on price should reduce the number of tiers over time, eventually ending up with a single uniform tax. Similarly, those that levy different taxes based on product characteristics should reduce and eventually eliminate these differential taxes.

Rely more on specific tobacco excises as the share of excise taxes in retail prices increases

Greater reliance on specific excise taxes maximizes the impact of tobacco taxes on public health by reducing the gap in prices between premium and low priced alternatives and limiting opportunities for users to switch down in response to tax increases. Applying the same specific tax to all brands of a given tobacco product sends the clear message that all are equally harmful. For countries that currently rely on an *ad valorem* tax or a mix of *ad valorem* and specific taxes, an appropriate first step would be to set a sizable specific tax that applies to all brands with an *ad valorem* tax applied above this. Over time, the *ad valorem* rate could be reduced with greater increases in the specific tax so that the total tax increases as a share of retail price and so that the specific tax accounts for a greater share of the total excise tax.

Rely more on excise taxes than on import duties

The effectiveness of import duties in generating higher revenues and increasing retail prices has been decreasing as countries adopt bilateral, regional, and global trade agreements. Consequently, relying on specific tobacco excises would ensure sustainability of tobacco tax revenues. For countries that currently rely heavily on import duties from tobacco products, an appropriate transition strategy would be to reduce import duties over time while adopting and increasing specific tobacco excises so that total taxes on tobacco products are increasing.

Adopt comparable taxes and tax increases on all tobacco products

Increasing excise taxes on some tobacco products but not on others results in changes in the relative prices of these products that induce substitution towards relatively less expensive products. As a result, the overall reduction in tobacco use is smaller than it would have been had all taxes increased by comparable amounts. Comparable increases in the taxes on all tobacco products maximize the public health impact of tobacco tax increases by minimizing opportunities for substitution. Similarly, increases in taxes on all tobacco products will generate larger increases in tobacco tax revenues than would increases in taxes on selected products.

Eliminate tax and duty free sales of tobacco products

The WHO Framework Convention on Tobacco Control, in Article 6, calls for “prohibiting or restricting, as appropriate, sales to and/or importations by international travellers of tax- and duty-free tobacco products”. Doing so increases the public health impact of higher tobacco taxes by raising all tobacco product prices and by reducing opportunities for tax avoidance while at the same time generating additional revenues.

Where revenue increases are a goal, rely on tobacco tax increases to achieve revenue increases

Industry price increases (when taxes are *ad valorem*) or increases in sales volume will generate increases in tobacco tax revenues, but tax increases are more effective in achieving public health goals and will generate new revenues in the short to medium term. Relying on increases in sales volumes to increase revenues will worsen the public health consequences of tobacco use. Relying on industry price increases to achieve revenue increases results in tobacco tax revenues being less predictable and more unstable over time, given the dependence on industry pricing strategies.

Automatically adjust specific tobacco taxes for inflation

Unless regularly adjusted, the real value of specific tobacco taxes will fall over time as general price levels increase. When this happens, the real value of tobacco taxes revenues will fall and the effectiveness of the tax in reducing tobacco use will be diminished. Governments can avoid this by establishing a mechanism for automatically adjusting specific taxes so as to keep pace with inflation. To date, only Australia and New Zealand have done this. To the extent that inflation is low, an annual adjustment should be sufficient; where inflation is higher, more frequent adjustment would be needed.

Increase tobacco taxes by enough to reduce the affordability of tobacco products

In order to maximize the public health impact of higher tobacco taxes, while at the same time generating higher revenues, governments should raise taxes so as to raise prices and reduce the affordability of tobacco products. In many LMICs, tobacco use increases with incomes and incomes are rising faster than tobacco product prices so that these products are becoming more affordable. In order to reduce affordability, tax increases need to result in real price increases that are higher than the increases in real incomes.

Include tobacco excise tax increases as part of a comprehensive strategy to reduce tobacco use

Governments should adopt a comprehensive tobacco control strategy that includes objectives for reducing adult tobacco use and preventing youth tobacco use. In addition to higher tobacco taxes, such a strategy should include other interventions to reduce tobacco use including, but not limited to, comprehensive smoke-free air policies, total bans on tobacco company marketing activities, strong warnings about the consequences of tobacco use, broad efforts to help current users quit, and mass media public education campaigns. Implementation of a comprehensive strategy to reduce tobacco use leads to greater reductions in the consequences of tobacco use, builds public and political support for higher taxes, and maximizes the effectiveness of tax increases in achieving public health goals.

Use a portion of tobacco tax revenues to support other tobacco control and/or health promotion efforts

Significant increases in tobacco product excise taxes generate substantial new revenues that can be used to support a variety of activities, including other tobacco control interventions and health promotion efforts. Empirical evidence demonstrates that using tax or other revenues to fund tobacco control programmes results in greater reductions in tobacco use than result from a tax increase alone. Experiences in many countries have demonstrated that public support for higher tobacco taxes is greater when at least some of the increased revenues are used to support health-focused programmes. Tobacco taxes in most countries generate hundreds or thousands of times more in revenues than are spent on tobacco control activities, leaving considerable room for increased funding of tobacco control programmes. While hard earmarking of tobacco tax revenues for tobacco control and other health promotion efforts may be infeasible in some countries, soft earmarking should be possible in all countries.

Do not view low taxes and prices for some tobacco products as a “pro-poor” policy

Keeping tobacco taxes and prices low on some products, so as to ensure affordability of these products for the poor, is not a pro-poor policy. Instead, it results in greater tobacco use among the poor, causing them to bear a disproportionate share of the burden of the health and economic consequences of tobacco use and increasing the likelihood of future poverty. High tobacco taxes on all tobacco products will result in greater reductions in tobacco use among the poor and to a progressive distribution of the health and economic benefits that result – a truly “pro-poor” policy.

Do not allow concerns about the regressivity of higher tobacco taxes to prevent tobacco tax increases

While existing tobacco taxes may be regressive given traditional measures of tax incidence, these taxes may be progressive once the greater price sensitivity of the poor and the externalities associated with tobacco use are taken into account. Even using traditional measures of tax incidence, tax increases can be progressive given differences in price responsiveness by income, with higher taxes increasing the overall share of tobacco taxes paid by higher income groups. Countries particularly concerned about the regressivity of tobacco excise taxes might employ an ad valorem tax on top of a high specific tobacco excise. To the extent that concerns about the impact of tax increases on the poor remain, these can be offset by using the revenues generated from a tax increase to support efforts to help poor tobacco users quit, other health promotion efforts targeting the poor, and/or other programmes directed to those in poverty.

Do not allow concerns about employment impact to prevent tobacco tax increases

Reductions in tobacco-dependent employment following tobacco domestic tax increases will be offset by increases in employment in other sectors as spending on tobacco products is replaced by spending on other goods and services. Given the capital intensive nature of tobacco product manufacturing in most countries, it is likely that there will be either no net impact on jobs or even a small increase in jobs following a tax increase. To the extent that there are concerns about job losses in tobacco-dependent sectors, using a portion of new tobacco tax revenues to move tobacco farmers into other crops and/or to retrain those employed in tobacco product manufacturing for work in other sectors would significantly reduce these concerns.

Do not allow concerns about the inflationary impact of higher tobacco taxes to deter tax increases

In most countries, either tobacco taxes are a relatively low share of tobacco product prices or the weight given to tobacco product prices in computing national price indices is low, implying that tobacco tax increases will generally have a small impact on inflation. To the extent that there are concerns about the inflationary impact of a tobacco tax increase given that wages or some government spending may be tied to a price index, governments can reduce these concerns by using a price index that excludes tobacco products, as recommended by the EU and, for example, done in France (for the index used to adjust minimum wages).

Strengthen tobacco tax administrators' capacity to monitor tobacco product markets and evaluate the impact of tobacco tax increases

Regardless of how well the tax system is integrated between the tobacco manufacturers and tax administrators, tax authorities should “trust but verify”. To accomplish this, a well established monitoring system should be put in place that employs new technologies for monitoring the production and distribution of tobacco products and that includes physical control over these products as they move through the distribution chain. In addition, tax authorities should audit taxpayer account books periodically. Where one does not already exist, a tobacco excise department should be established. This department should collaborate with Customs in order to minimize non-compliance and monitor trade. It should also maintain and update a comprehensive database for use in assessing tobacco product markets, conducting analyses of demand for tobacco products, and evaluating current tobacco excise taxes and the impact of increases in these taxes. Such efforts will be most effective when done in cooperation and collaboration with tax authorities from neighbouring countries and regional and global organizations.

Adopt new technologies to strengthen tobacco tax administration and minimize tax avoidance and evasion

Tax administrators should adopt up-to-date technologies in order to increase the efficiency of tax collection and minimize tax avoidance and evasion. These new technologies include more sophisticated, harder to counterfeit tax stamps and tracking-and-tracing systems that can be used to follow tobacco products through the distribution chain. Tax authorities should be able to assess production levels and accurately estimate manufacturers' tax liabilities, independent of claims filed by tobacco manufacturers. Adoption of these technologies could be financed by small increases in tobacco excise taxes, when needed; in most countries, it is likely that the adoption of these technologies would more than pay for itself through the revenues collected on products for which taxes would otherwise not have been paid.

Strengthen tobacco tax administrators' capacity by licensing all involved in tobacco product manufacturing and distribution

Licensing of all involved in tobacco production and distribution facilitates monitoring of tobacco product markets, makes it easier to identify illicit tobacco products, and increases administrators' ability to identify and penalize those engaged in tax evasion. This is particularly true when done in combination with the adoption of the technologies discussed above.

Ensure certain, swift and severe penalties for those caught engaging in illicit trade in tobacco products

Economic theory and empirical evidence demonstrates that an increase in the expected penalty for illegal behavior reduces crime. Strong tobacco tax enforcement will raise the likelihood that those engaging in illicit trade in tobacco products will be caught, while high administrative penalties will raise the swiftness and severity of the punishment for such illegal activity. Stronger enforcement efforts would almost certainly more than pay for themselves through the increased taxes collected from previously untaxed products. Countries that have significantly increased enforcement efforts and raised penalties have effectively reduced illicit trade in tobacco products. This is particularly true when they “go after the big fish” – those running the illicit operation – rather than focusing on those at the end of the distribution chain.

Conclusions

Tobacco excise taxes are a powerful tool for protecting public health while at the same time an efficient source of government revenues. The best practices identified above should help governments in maximizing the impact of tobacco taxes in reducing tobacco use and its consequences, while at the same time enhancing the revenue generating capacity of these taxes. As governments begin to make the transition from their current practices to the “best practices”, much will be learned and best practices will be refined.