TAXING TIMES

A critical look at the fiscal treatment of tobacco

By Jeannie Cameron

It was back in September 1999 that the World Health Organization was floating the idea of post-FCTC international regulation for tobacco price and taxation policy—and that was before the FCTC itself had even started to be negotiated. In the 1999 WHO document *Subjects of possible protocols and their relation to the framework convention on tobacco control*, nine tobacco issues are listed for potential protocol (sub-treaty) development. Price is the first one.

Prices. Harmonization of taxes on tobacco products at the international level is necessary to avoid excessive price differences among neighboring countries.

In the following *Solutions* section, the authors suggest the following:

At international level an option would be to propose that taxes (excise duties + VAT) on cigarettes must account for at least 70 percent of the final retail price and that hand-rolling tobacco should be taxed in the same way as manufactured tobacco products. … Transition periods along the following lines could be foreseen for countries with low taxes to enable them to comply with those targets.

Rate of tax on cigarettes (1 January 2000)	Length of transition period
<55 percent	3 years
<45 percent	6 years
<35 percent	9 years
<25 percent	12 years

These kinds of IGO (international government organization) documents are, for all intents and purposes, road maps for future national legislation—such is the way of multilateral treaty-making once the political impetus gets going. Indeed, the 1999 document highlights the role the incremental method of international lawmaking will play to bring about the desired policy outcome: "… the framework convention and protocol approach will allow for the incremental development of an international legal regime for global tobacco control …."

Developments over the past decade

In 2003, the 193 government members of the WHO unanimously adopted the Framework Convention on Tobacco Control (FCTC), agreeing with each other that they would implement price and tax measures to nationally reduce the demand for tobacco. In 2005 the FCTC entered into force as international law and is legally binding on the 174 parties. Article 6 of the FCTC requires all parties to recognize that price and tax measures are an effective means of reducing tobacco consumption and that "… without prejudice to the sovereign right of the parties to determine and establish their taxation policies," they should take account of national health objectives.

In particular Article 6.2(a) obliges parties to implement tax policies, and where appropriate, price policies, on tobacco products so as to contribute to the health objectives aimed at reducing tobacco consumption. Article 6.2(b) prohibits or restricts sales to, and/or importations by, international travelers of tax and duty-free tobacco products. Article 6.3 and Article 21 require parties to report rates of tax and trends to the WHO. As a result, over the past 10 years there have been steady increases in tobacco taxation globally, the issue of duty-free sales of tobacco has become significant within the developing FCTC Protocol on Illicit Trade, and the WHO is slowly compiling a repository of tobacco taxation data on which to base future taxation policy.

The FCTC gives "civil society" an official role in its implementation (it is one of the first to do this), and during 2007 and 2008

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> —JOHN BRAITHWAITE AND PETER DRAHOS
> GLOBAL BUSINESS REGULATION, 2000

tobacco taxation policy became a focus for tobacco control funding. The Bloomberg philanthropies and the Bill and Melinda Gates Foundation made tobacco taxation one of their key areas for the allocation of $125 million over two years to enhance tobacco control in low- to middle-income countries—*double* the total private and public donor resources devoted to tobacco control in developing countries at that time.

The funding enabled the WHO to release a report on the global tobacco epidemic known as the MPOWER document, the R in the acronym signifying "Raise taxes on tobacco." Tobacco taxation literature was suddenly everywhere—a series of impressive documents written by economists and experts on many different countries were produced and widely disseminated. It had a specific purpose.

At the eleventh hour of the third meeting of the FCTC Conference of the Parties (CoP3) in Durban, South Africa, in November 2008, the Philippines, representing the WHO Asia Pacific region, put forward a resolution calling on the CoP to invite the WHO Tobacco Free Initiative (TFI—the tobacco control policy department of the WHO) to develop internationally applicable guidelines relating to tobacco price and tax.

The proposal was agreed to by each of the other WHO regions, and the final wording of the resolution, put forward by France on behalf of the EU, that changed "guidelines" to "technical report," was accepted. Only Japan reminded parties that taxation was the "sovereign right of states" and asked whether there really was a need for international intervention. Of course there was, and the resolution was adopted. The WHO TFI was given authority to proceed toward producing the technical report with the input of experts in time for CoP4 in November 2010. It should have been no surprise to anyone that this would happen.

A process on a roll

But before the WHO released its technical report, it managed to produce the comprehensive 137-page *Manual for Tobacco Tax Administration*. Just how the world's international health organization was able to produce such an impressive tome without any counterargument from any financial institution or the tobacco industry was remarkable—could it have been a kind of policy Stockholm syndrome?

If one were to be speculative, one might assume that the manual's 20 summary recommendations are likely to become the Article 6 guidelines to be presented at CoP5 in November 2012. They are significant:

1. Use tobacco excise tax increases to achieve the public health goal of reducing the death and disease caused by tobacco use.
2. Set tobacco excise tax levels so that they account for at least 70 percent of the retail prices for tobacco products.
3. Simpler is better—aim to implement a single uniform tax on a given tobacco product.
4. Rely more on specific tobacco excises as the share of excise taxes in retail prices increases.
5. Rely more on excise taxes than on import duties.
6. Adopt comparable taxes and tax increases on all tobacco products.
7. Eliminate tax and duty-free sales of tobacco products.
8. Where revenue increases are a goal, rely on tobacco tax increases to achieve revenue increases.
9. Automatically adjust specific tobacco taxes for inflation.
10. Increase tobacco taxes by enough to reduce the affordability of tobacco products.
11. Include tobacco excise tax increases as part of a comprehensive strategy to reduce tobacco use.
12. Use a portion of tobacco tax revenues to support other tobacco control and/or health promotion efforts.
13. Do not view low taxes and prices for some tobacco products as a "pro poor" policy.
14. Do not allow concerns about the regressivity of higher tobacco taxes to prevent tobacco tax increases.
15. Do not allow concerns about employment impact to prevent tobacco tax increases.
16. Do not allow concerns about the inflationary impact of higher tobacco taxes to deter tax increases.
17. Strengthen tobacco tax administrators' capacity to monitor tobacco product markets and evaluate the impact of tobacco tax increases.
18. Adopt new technologies to strengthen tobacco tax administration and minimize tax avoidance and evasion.
19. Strengthen tobacco tax administrators' capacity by licensing all involved in tobacco product manufacturing and distribution.
20. Ensure certain, swift and severe penalties for those caught engaging in illicit trade in tobacco products.

In addition to the activity of the WHO outside the official FCTC process, there was also a lot going on within the official process. Without any views of opposition expressed from anyone, the CoP adopted partial guidelines on taxation within the context of the FCTC product guidelines, and these were officially agreed by consensus of the 174 governments at CoP4 in November 2010. These now form part of the Annex to the Tobacco Product guidelines and recommend to governments that in order to alleviate budgetary pressure, these costs could be placed on the tobacco industry and retailers, via the following means:

(a) designated tobacco taxes;

(b) tobacco manufacturing and/or importing licensing fees;
(c) tobacco product registration fees;
(d) licensing of tobacco distributors and/or retailers;
(e) noncompliance fees levied on the tobacco industry and retailers;
(f) annual tobacco surveillance fees (industry and retailers).

Also at CoP4, the WHO Technical Report was officially released and the international process remained on track—it had three main conclusions:

1. When governments set taxes, it is important that they are set so as to reduce the affordability of tobacco products to such an extent that there are significant reductions in tobacco use and its consequences, particularly among those most at risk of taking up tobacco use (young people) and among those who bear the disproportionate burden of health and economic consequences of tobacco use (economically disadvantaged people).

2. A tax structure that raises the prices of all tobacco products and minimizes the gap between the prices of low- and high-priced brands of a given type of tobacco product reduces opportunities for tobacco users to switch to cheaper brands/products in response to tax increases, thus maximizing the health impact of a tobacco tax increase.

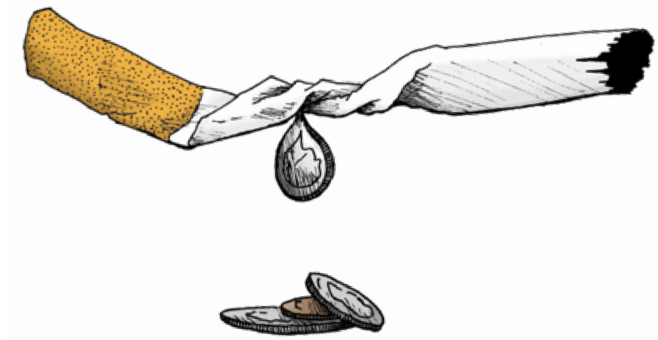
3. Given the significant new revenues that can be generated by tobacco tax increases, these revenues have the potential to support comprehensive tobacco-control efforts, thereby adding to the health and economic benefits of tobacco tax increases by further reducing tobacco use.

Consensus is the absence of a formal objection, and as there was no objection, it was agreed by the majority of the world's governments that an international working group to develop international guidelines for tobacco price and tax would be established. Draft guidelines are expected to be presented to CoP5 in November 2012. The CoP4 regulatory brick had been cemented in.

The unintended consequence

Before the first brick was laid, the issue of illicit trade was raised in the 1999 WHO document referenced above: "The smuggling issue has now become the most convincing argument to counter the policy of governments that want to reduce the consumption of tobacco through taxation. In its report on taxes on tobacco products of May 1998, the European Commission stressed that the smuggling factor must be taken into account when a tax increase is considered, as the public health objective of reducing consumption through high taxation will fall short of its target if tobacco products evade this taxation.

Most countries now have an excise-to-illicit trade story. In



Canada, increased illicit trade has led to a decline in government revenues, and excise tax increases since 2005 have been nullified. In 2008, Canadian tobacco tax revenues were C$847 million (US$853.7 million) lower than in 2004. In Ireland the government increased tobacco excise by a massive 68 percent between 2001 and 2009, and the result was not only a massive increase in illicit trade and organized crime, but smoking incidence data show that there was no decline in cigarette consumption. In Malaysia excise was increased by 21 percent per annum between 2001 and 2009—a rate almost 10 times more than inflation, at just 2.3 percent per annum. Illicit trade exploded and smoking incidence remained static.

In the U.S. state of New York, in 2001, a 62 percent excise duty increase resulted in federal and state tax reaching $73 per 1,000 cigarettes. In 2002, a 30 percent combined increase was added, and further significant increases followed in 2008 and 2009—far above the rate of inflation. By 2010, New York had the highest taxes in the United States at $267 per 1,000. Between 2000 and 2008 tax-paid volumes declined by 42 percent and, according to several sources, the rate of illicit trade increased dramatically. According to a 2008 study by the Mackinac Center for Public Policy between 1990 and 2006, the average incidence of smuggled cigarettes in New York was 20.9 percent and it reached 40.8 percent in 2006. Another study in 2009 by the New York Association of Convenience Stores estimated that 44 percent of total cigarette consumption in the 2007-2008 fiscal year was untaxed. This has meant that in New York there has not been any significant additional revenue since 2002, despite the hefty tax increases.

If the stated public health objective is to reduce tobacco consumption through higher tax, it can only go so far before the pendulum starts to swing the wrong way. Governments need to ensure they balance tax and health policy, otherwise the biggest impact might be the unintended consequence of illicit trade, which benefits no one—least of all governments.

Is that brick wall being built? Is anyone noticing how high it has already got? TR