

IMF Advice on Tobacco Taxation

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and Health Promotion Foundations

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Overview

- I. IMF interest in tobacco taxes
- II. The level of tobacco taxes
- III. The design of tobacco taxes
- IV. Earmarking of revenue
- V. EU tobacco tax coordination

I. IMF interest in tobacco taxes

- Support countries seeking to improve macroeconomic and fiscal policies
- Technical assistance on the design and implementation of tax policy, including tobacco excises
- Some Fund-supported programs have included increases in tobacco taxes for revenue purposes
- Recent Bank/Fund workshop on tobacco-issues highlighting the health policy link

II. The level of tobacco taxes

- Guidance from tax policy
- Constraints from smuggling and undervaluation
- Concern about the equity impact

Tax policy: why a high tax on tobacco?

- Ramsey tax rule \Rightarrow the lower the demand response to price, the higher the tax rate
- Tobacco demand is relatively price inelastic (-0.4 in rich; -0.8 in poor countries);
- Tobacco consumption generates negative externality \Rightarrow corrective Pigouvian tax
- Addictive nature of nicotine, combined with myopia and information failure \Rightarrow addiction tax (self-control mechanism)?

Smuggling: constraint on tax policy

- Bottlegging, smuggling, and undervaluation a constraint on tax policy
- Tax policy coordination...or cooperation on tax administration and enforcement?
- Many factors at work in determining smuggling (e.g., tax-induced price difference, administrative capacity, corruption, or societal acceptance of illicit trading)

Equity concerns

- Smoking prevalence higher for poor men than rich men (globally); evidence for women more mixed?
- Tobacco taxes do tend to be regressive
- Are the health benefits from increases in tobacco taxes progressive?
- But a real burden for the poor of any additional tax

Back to the level of taxes

- Tax rates *can* become too high, reducing revenue and even undermining tobacco control objectives if tax-not-paid cigarettes substituted
- But modest increases in tax rates are likely to be revenue positive and have health benefits
- Motivation for tax: combination of paternalistic concerns (tax the bads) and revenue needs?
- Need for offsetting equity measures (expenditure side?)

III. The design of tobacco taxes

- What tobacco products should be taxed
- Choice of tax instruments
- Specific vs. ad valorem

What products should be taxed

- Spread the tax net, but be realistic about administrative cost
- Cigarette consumption is most important
- But capture cigars, pipe tobacco, roll-it-yourself
- How to treat “informal” tobacco products?
 - Equity issues; administrative costs

Choice of tax instruments

- Combination of excise, import duties, and VAT/sales tax
- Collect at manufacturing stage (ex-factory) + imports
- Careful that multiplier effect does not become excessive

Specific vs. ad valorem tax

- Choice between specific, ad valorem, ad valorem with specific floor, and mixed
- Difference in administrative requirements
- Undervaluation concerns: specific excise or floor
- Impact on product “quality” and price (multiplier effect)
- Inflation (index specific component automatically or adjust regularly)
- Health benefits linked to volume or price?

IV. Earmarking of revenue

- When is there a case for earmarking?
 - A user fee for the public provision of a “private” good (excludability, rivalry)
 - A tax on the consumption of private goods (e.g., petroleum) that is a close approximation for a public good (e.g., road usage)
- What are the problems with earmarking?
 - Excessive earmarking undermines macroeconomic policy control
 - Expenditure choice escapes the political tradeoff in the budget process
 - Contagious, even addictive, demand for earmarking (approving one, leads to demands from others)

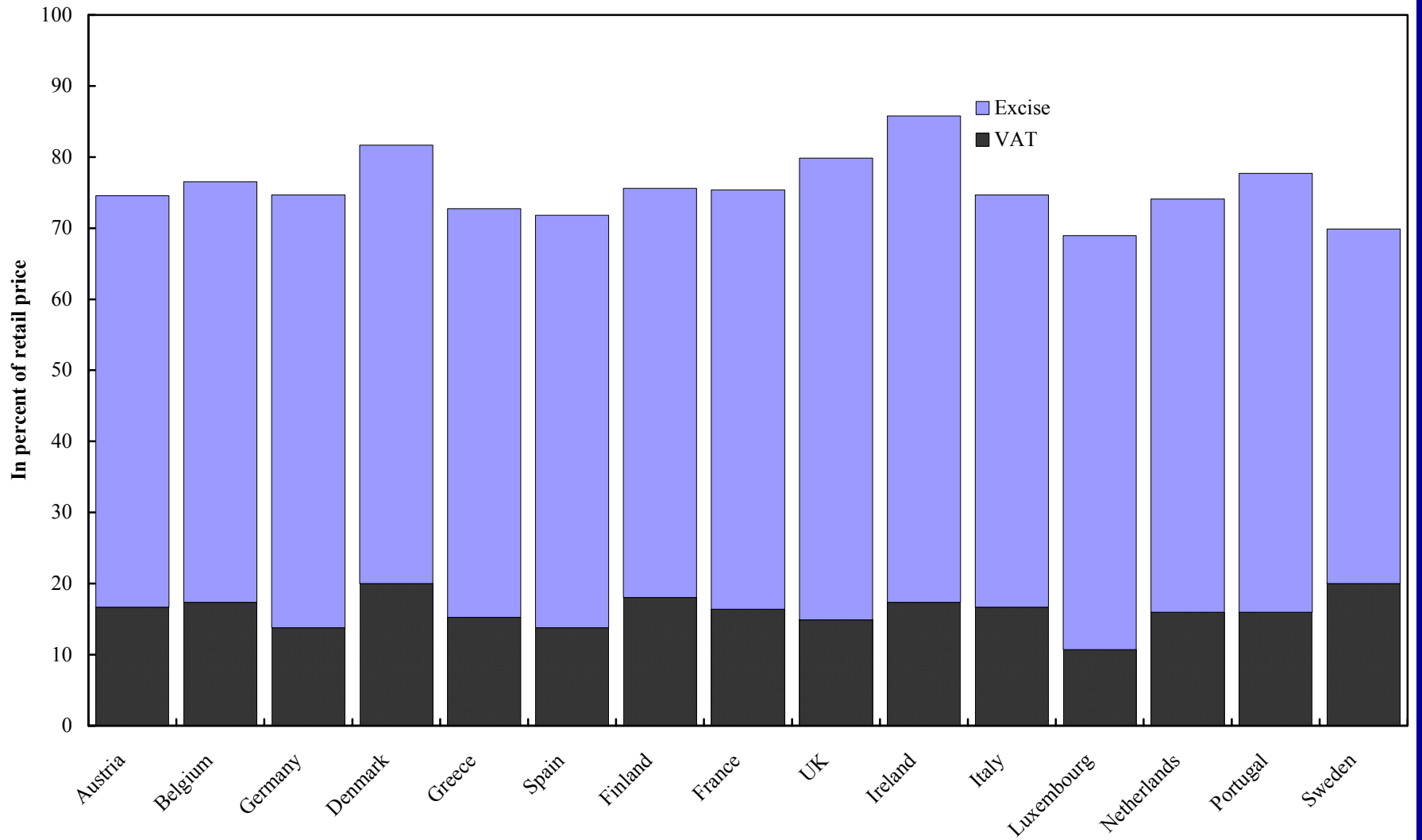
Is there a case for tobacco tax earmarking?

- Should (part of) a tax on tobacco (a private good) be earmarked to a fund for tobacco control (a public health benefit)?
- Tobacco control expenditure only amounts to a small proportion of tobacco taxes
- Public costs of smoking are scattered across many budget institutions
- Fungibility of money: will earmarked revenue replace otherwise budgeted funds?
- Any reasons why the allocation of public funds for tobacco control should not pass through the budget decision-making process?

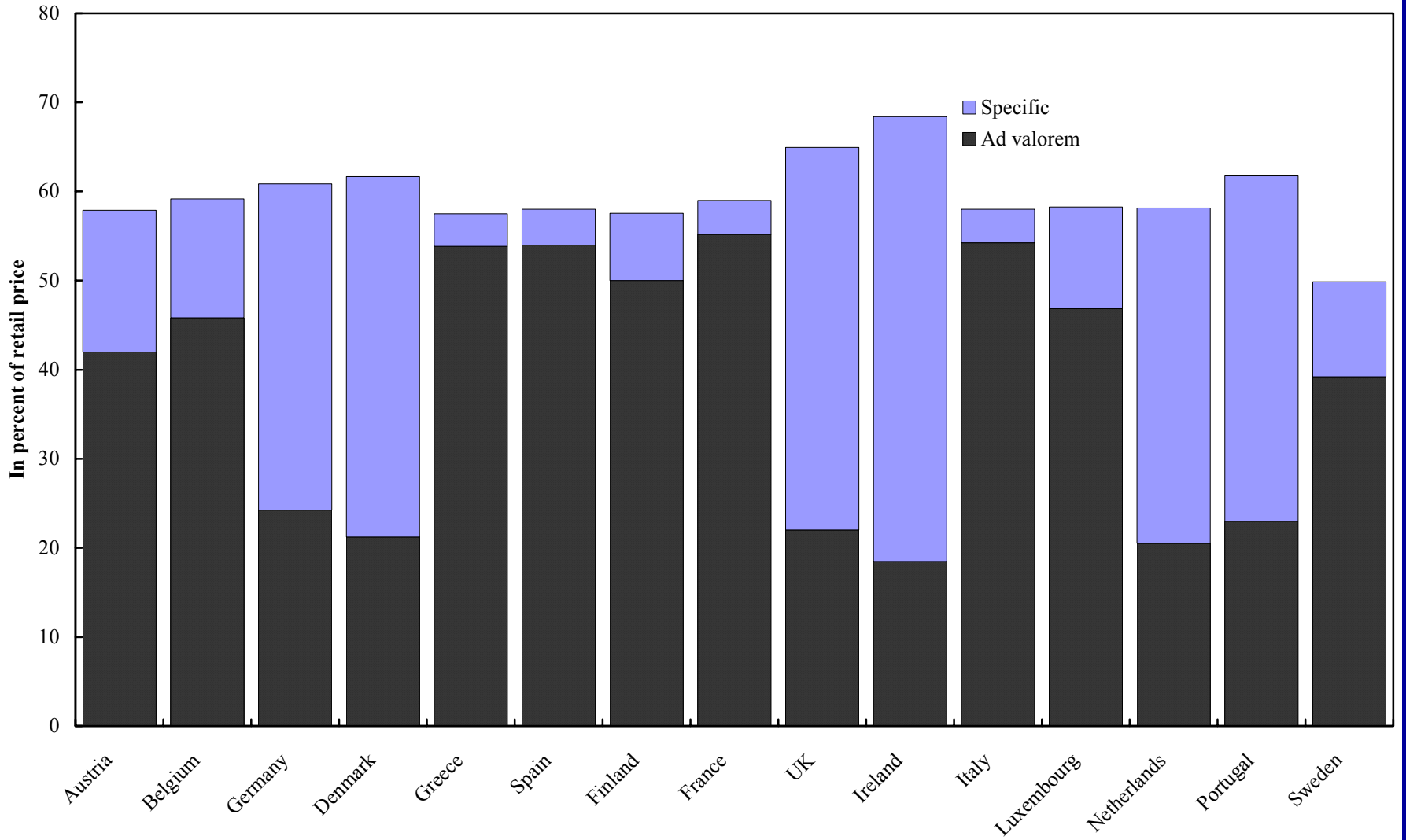
V. EU tobacco tax coordination

- Single European Market created pressure for harmonization of tobacco excises
- Tobacco directive (outcome of political process)
 - Total excise (specific + ad valorem): at least 57 percent of retail price;
 - Specific excise: 5-55 percent of total tax
 - Min. excise: € 60 per 1,000 cigs
 - VAT rate: at least 15 percent (VAT exclusive) or 13.04 (VAT inclusive); total combined tax at 70 percent.
 - Compliance with min. tax calculated on “most popular price category
- Countries are clustered around the min-max specific excise limits

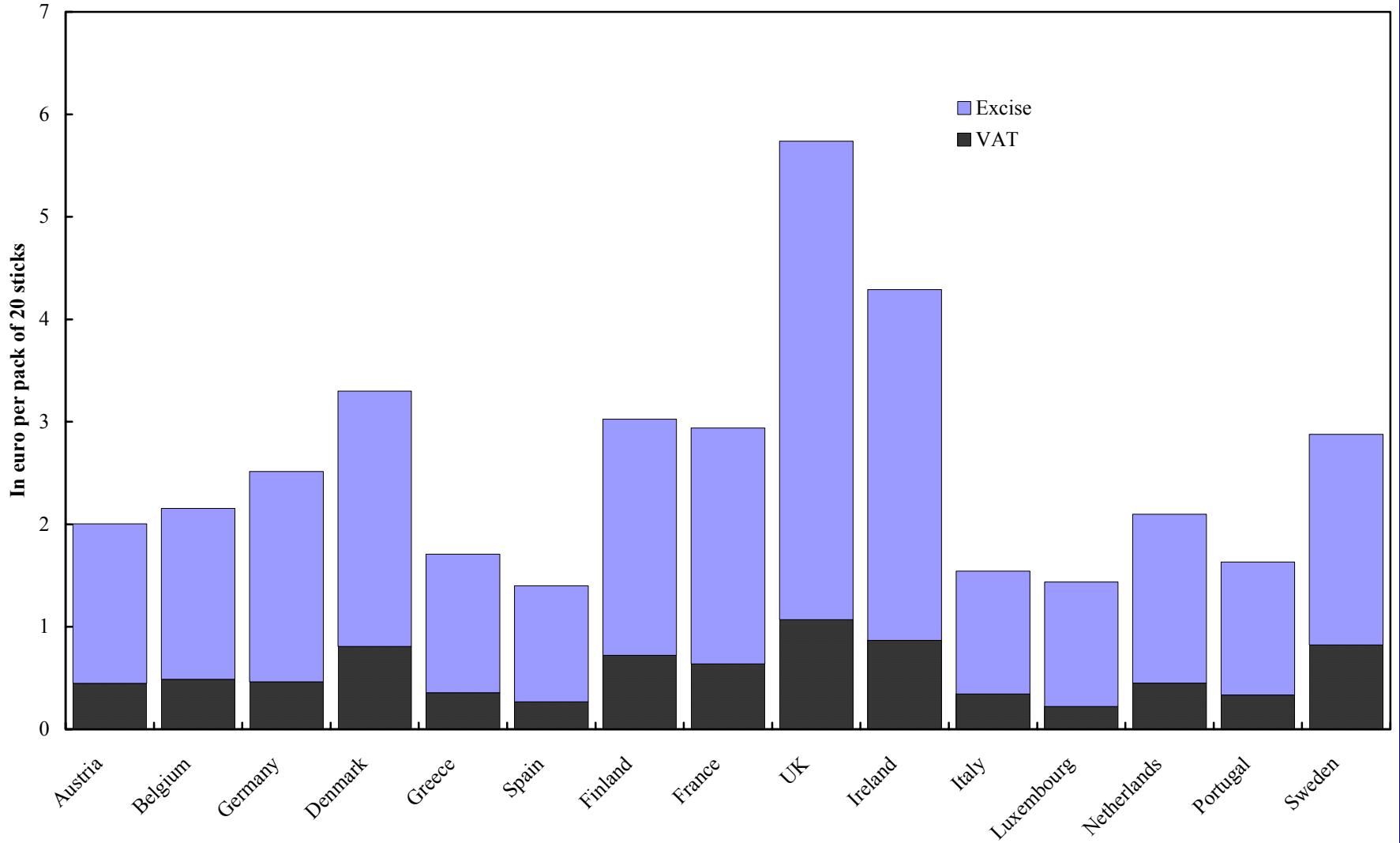
Figure 1. Total tax on cigarettes



Total excise on cigarettes



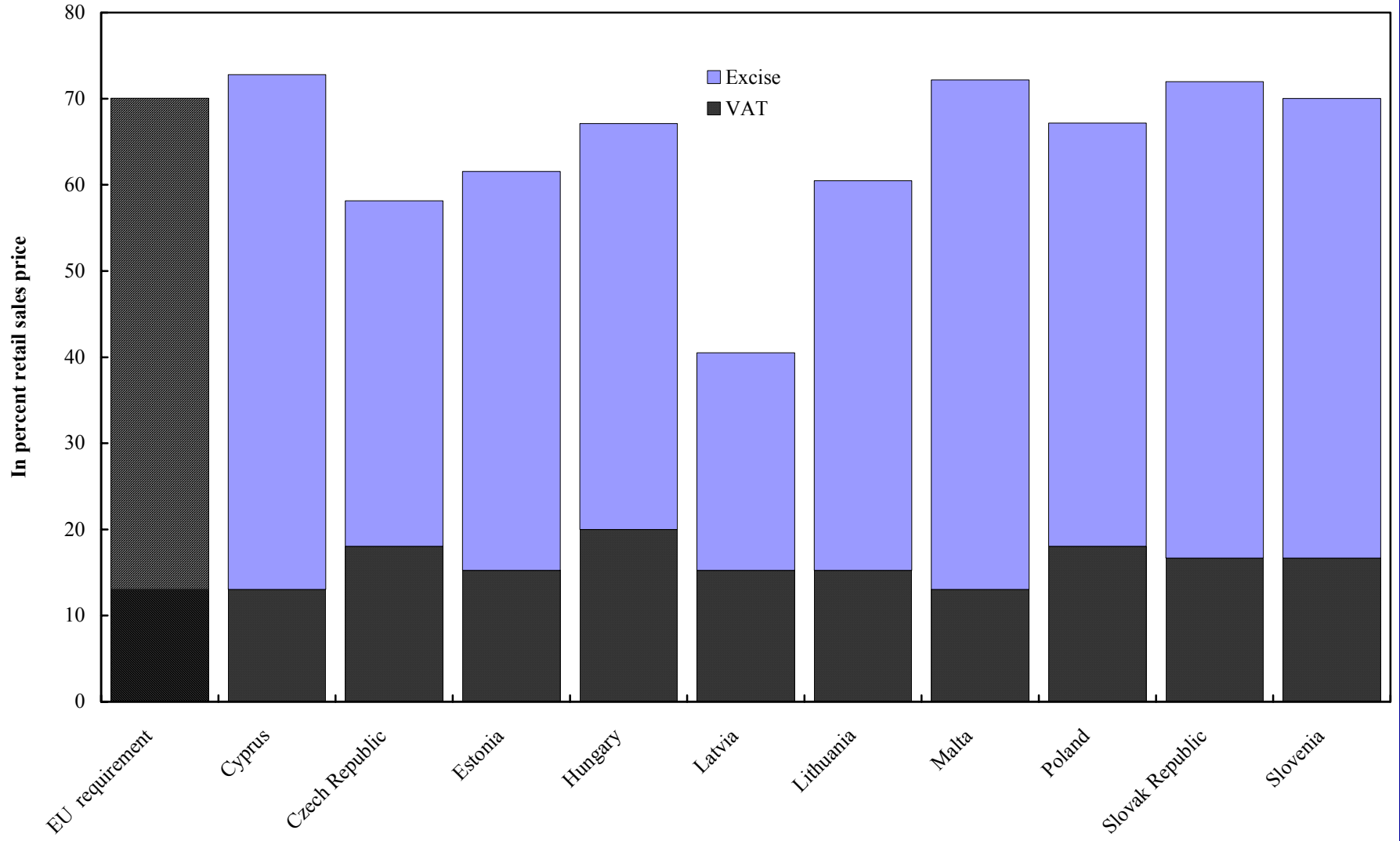
Total tax on cigarettes



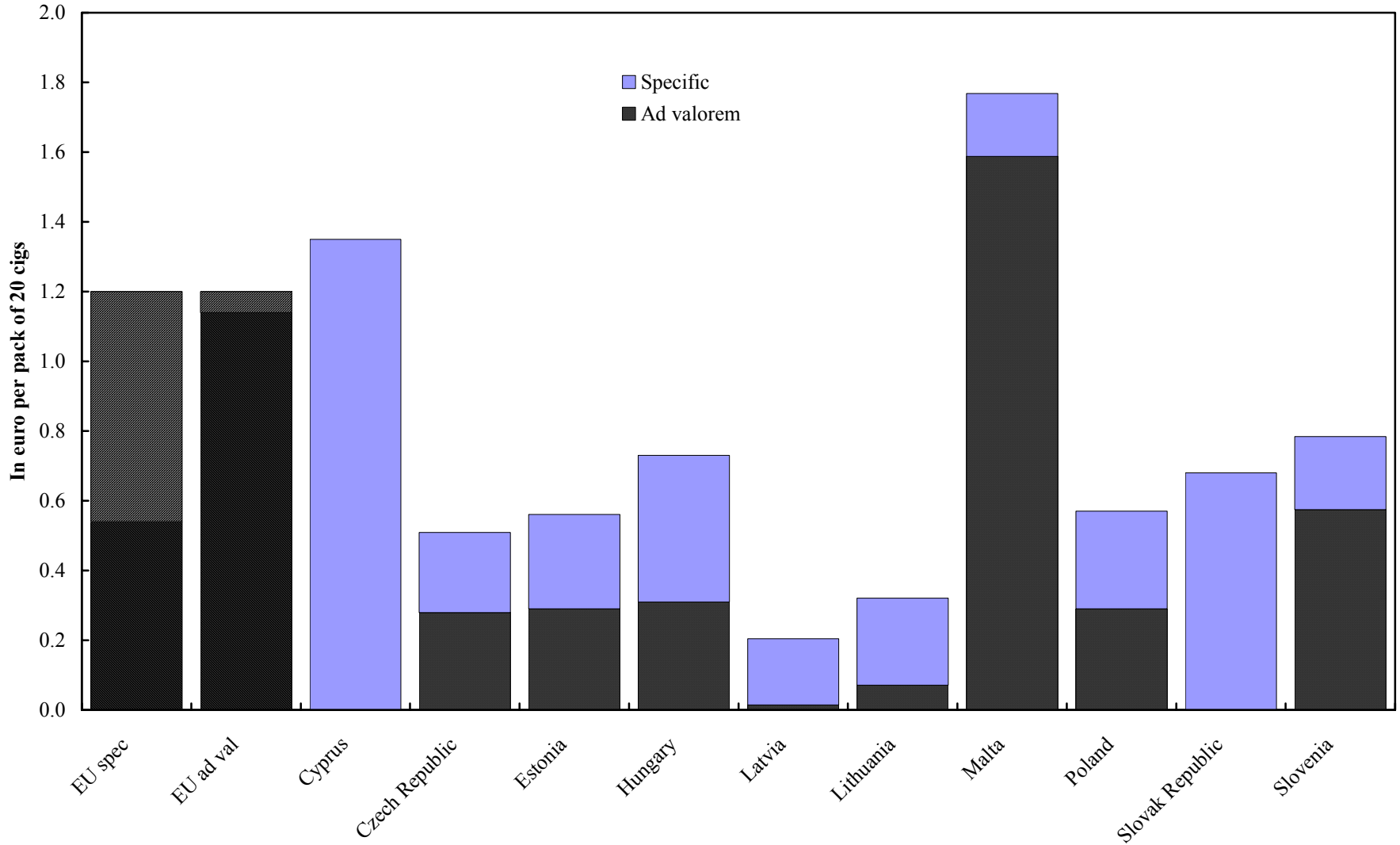
EU Accession countries

- Tobacco tax requirements—adjustment for accession countries
- Need to increase substantially tobacco taxes, but transition periods 2007-09.
- Concerns have been expressed about:
 - Length of transition period
 - Smuggling (large tax differentials relative to neighboring non-EU countries; weak customs and enforcement capacity)
 - Affordability and equity impact

Accession countries: Tobacco tax incidence



Accession countries: Excise Burden Per Pack of Cigarettes



Conclusion

- The Fund has an interest in tobacco taxation (and hence tobacco control), mainly through the fiscal connection
- The optimal tax rate is not infinite, but modest tax increases likely to be revenue positive and bring health benefits
- The design of the tax regime matters (some advantages from specific excise)
- Weak case for earmarking of tobacco tax, and concerns about “contagion”
- Tobacco tax harmonization an administrative and policy challenge for EU accession countries