



<http://www.tobaccoevidence.net>

## Tobacco Tax Design

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# Criteria for evaluating taxes

- **Efficiency** (neutrality for market incentives)
- **Equity** (fairness)
- **Simplicity**
  - Minimising public administrative costs
  - Minimising private compliance costs
- **Vulnerability to tax avoidance** (legal exploitation of tax loopholes)
- **Vulnerability to tax evasion** (reducing tax by illegal means)

# Efficiency

- Generating revenue with the minimum amount of distortion of resource allocation (unless deliberate) - Tobacco taxes aim to deliberate **distort incentives** (to reduce smoking)
- Desirable to have **a broad-based, uniform rate** system so that the tax cannot be avoided by switching to another brand or type of tobacco
- For example, **import duty** could be avoided by switching to domestically-produced tobacco; different taxes on cigarette and **RYO tobacco**

# Equity (fairness)

- Alleviating (or not increasing) **poverty**
- There are more effective ways than tobacco taxes to achieve fairness
  - Broad-based (non discriminatory) consumption taxes
  - Income taxes
- But the best way to help the poor is to provide **public social welfare** and pay for health expenditures
- Could be funded from tobacco tax revenue (**earmarked tax**)

# Simplicity

Goal is to achieve:

- **Low compliance costs** – minimising costs imposed on business in collecting the tax and remitting it to the tax authorities
- **Low administrative costs** – minimising the costs imposed on the public sector in administering and collecting the tax

# Vulnerability to tax avoidance and tax evasion

- Some types of taxes are much more vulnerable:
- **Narrow-based taxes** (taxes with multiple exemptions) as opposed to **broad-based taxes**
- **Taxes with multiple rates** as opposed to **single rate taxes**
- **Retail taxes** as opposed to **wholesale taxes** (many more taxing points are difficult to oversee and result in many more cash transactions)

# The Numbers Principle of Economic Policy

- For efficient economic policymaking the **number of economic instruments** must be at least equal to the number of targets
- **Targets** are the objectives of economic policy (for example, reducing smoking, reducing poverty)
- **Instruments** are policies designed to achieve targets (for example, taxation)
- Thus tobacco taxation cannot be used both to reduce smoking and, **at the same time**, to reduce poverty in the short run

# Categories of Taxes

## Ad valorem taxes

- Applied as a percentage of some value (for example, wholesale price)
- Automatically indexed (as cigarette prices rise, tax revenue automatically rises)

## Specific taxes

- Tax base is a physical measure (for example, per kilo of tobacco or per stick)
- Not automatically indexed

# Types of Taxes (1)

## Value-added tax (VAT)

- Efficient (especially if broad-based, single rate)
- High administrative and compliance costs (especially if exemptions and multiple rates)
- Values are harder to measure than physical quantities
- Many taxing points
- Vulnerable to evasion at retail level through the cash economy. Relatively invulnerable at other levels
- Automatically indexed
- High rates politically difficult
- For these reasons, difficult to use to discriminate against smoking

# Types of Taxes (2)

## Retail sales tax

- Automatically indexed
- Relatively high administrative and compliance costs
  - Many taxing points
- Highly vulnerable to evasion
  - Most transactions in cash
  - Many taxing points

## Wholesale sales tax

- Automatically indexed
- Lower administrative and compliance costs
  - Fewer taxing points
- Less vulnerable to evasion
  - Fewer cash transactions
  - Fewer taxing points

# Types of Taxes (3)

## **Excise duty (specific tax)**

- **Relatively low administrative and compliance costs**
  - Fewer taxing points
- **Less vulnerable to evasion**
  - Fewer taxing points
  - Fewer cash transactions
- **Physical quantities are easier to measure than values**
- **Not automatically indexed and difficult to legislate for new rate each year**
- **But automatic indexation is possible, for example by legislating automatic link between rates and price indexes**
- **Per stick taxes may encourage the production of longer cigarettes (e.g. “super king sized”)**

# Types of Taxes (4)

## **Import duties (customs duties, tariffs)**

- **Low administrative and compliance costs**
  - Relatively few taxing points
- **Inefficient**
  - Distorts resource allocation towards protected domestic industry
  - Better to have an efficient tobacco industry which can be heavily taxed, yielding high revenue to fund other expenditures
- **Vulnerable to avoidance (by switching to domestically produced cigarettes)**
- **Vulnerable to evasion (through smuggling)**

# Tax Design - Conclusions

- Different circumstances exist in different countries and one size does not fit all

## Recommendations

- **Broad-based, uniform rate**
  - For example, maintain consistency of rate between cigarettes and roll-your-own tobacco
- **Relatively few collection points**
- **No discrimination against imports**
- **VAT is not easy to use to discriminate against tobacco**
- **Specific excise tax (with automatic indexation) or wholesale sales tax have most advantages**