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Draft guidelines for the implementation of Article 6 of the WHO Framework Convention on Tobacco Control

Report of the working group

1. At its fourth session (Punta del Este, Uruguay, 15–20 November 2010), the Conference of the Parties (COP) decided[1] to establish a working group, composed of fiscal and health experts, and requested the working group to present a progress report or, if possible, draft guidelines for the implementation of Article 6 (*Price and tax measures to reduce the demand for tobacco*) of the WHO Framework Convention on Tobacco Control (WHO FCTC), for consideration by the COP.

2. In accordance with that decision, at its meeting of 6–8 December 2011, the working group discussed a first draft developed by the Key Facilitators. In the light of the discussion at that meeting and comments received, work was taken forward at a meeting of the Key Facilitators and several Parties that had expressed interest in participating at the beginning of March 2012.

3. The draft guidelines were made available to Parties on 11 May 2012 for comments (on a protected web site) with a deadline for comments of 25 June 2012.

4. Given the substantial and sometimes conflicting nature of many of the comments received, the Key Facilitators decided to take into account only linguistic and editorial changes that would improve the presentation of the guidelines at this stage and to submit the other comments to the COP for consideration.

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[1] See decision FCTC/COP4(13).

CONSIDERATIONS REGARDING COMMENTS RECEIVED

5. The sovereign right of the Parties to establish their own taxation policies is currently outlined as the first guiding principle. Some Parties felt that the issue should be even more emphasized in the guidelines. On the other hand, some Parties asked that the public health objectives of the WHO FCTC in general and the guidelines on implementation of Article 6 in particular be highlighted more. The Key Facilitators generally felt that a balance had been struck between the two views.

6. In relation to broader economic policy considerations, the draft text refers to aspects of affordability, and considers the need to take inflation and incomes into account when applying tobacco taxation. The view was expressed by some Parties that the role of tobacco products as a driver of inflation be examined in the guidelines. However, the Key Facilitators felt that this would exceed the scope of the guidelines.

7. As regards possible industry interference in tobacco taxation and health policies, some Parties felt that this risk should be highlighted in a strong way. Other Parties felt that the reference in the text to protection from vested interests should be worded exactly as in article 5.3 of the WHO FCTC and refer to the protection of “public health policies with respect to tobacco control”. Some comments suggested that text be added to describe the possible and most common tobacco industry responses to increasing tax rates.

8. In the comments received there were divergent views on how to assess and present the respective advantages of different tax systems and on how to refer to country/regional experience in this respect. Some Parties felt that the description of certain systems should not be part of the guidelines. Some Parties expressed concerns as regards the recommendation for a mixed tax structure (specific and ad valorem with a minimum tax floor) as such a structure would not be easy to administer and could not be simply “copied” even if certain regions gained widely positive experience in applying such a tax structure. Others again insisted on the advantages and good experience gained with such a structure and stressed that it is only recommended alongside a specific tax rate structure (which is already recommended), where the need for a simpler and more robust approach prevails.

9. Generally speaking, there was consensus that the substitution of one tobacco product by another should not be encouraged by the tax system. However, diverging views exist on how to achieve this result and on the feasibility of having similar tax burdens on different tobacco products in all circumstances – and on how to measure such a tax burden. Some Parties strongly supported having the guidelines refer to an equal (or similar or comparable) tax burden for different products, while others consider that the guidelines should not recommend a similar tax burden on different tobacco products as this would be the sovereign right of each Party to decide.

10. Most of the comments on the sections on tax administration argued that the text is too prescriptive. Some Parties, on the contrary, requested even more detailed information and operational guidance. As regards authorization/licensing and tracking and tracing, in particular, it was pointed out that these issues are covered by the draft protocol on the elimination of illicit trade in tobacco products.[1]

[1] The text of the draft protocol to eliminate illicit trade in tobacco products was agreed by the Intergovernmental Negotiating Body on a Protocol on Illicit Trade at its fifth session, which closed on 4 April 2012. The text was submitted for adoption by the COP at its fifth session (document FCTC/COP/5/6).

11. The use of revenues from tobacco taxes for tobacco control ("earmarking") received comments from different angles: while some Parties asked for stronger text and a clear recommendation in favour of "earmarking", others do not consider that this topic should be part of the guidelines at all. The Key Facilitators felt that a balance had been struck between the two views.

12. As regards tax-/duty-free sales and illicit trade, comments mainly expressed concerns about consistency with the draft protocol on the elimination of illicit trade in tobacco products and Article 15 of the WHO FCTC. Some comments also suggested that the recommendations, in particular on tax-/duty-free sales, go too far. The Key Facilitators generally felt that the current text ensures compatibility with the draft protocol on the elimination of illicit trade in tobacco products. However, the COP may wish to include the matter of consistency in its deliberations.

13. As regards the topic of international cooperation, some Parties and observers accredited to the COP suggested that the text should be strengthened and that the importance of available, comparable data (including from regular reporting) and of technical assistance should be highlighted. While some comments called for a clear commitment to a regular review of the guidelines, others considered that a review mechanism is not appropriate or cost-effective.

14. In line with some comments received, the original Annexes containing definitions and a bibliography (literature/references) were removed. This ensures a more coherent presentation and leaves the issue of definitions of different tobacco products to a more horizontal approach, if so decided by the COP.

ACTION BY THE CONFERENCE OF THE PARTIES

15. The COP is invited to review the draft guidelines and to consider their adoption, taking into consideration, inter alia, the issues listed in this note.

ANNEX

DRAFT GUIDELINES ON ARTICLE 6 OF THE WHO FCTC

Price and tax measures to reduce the demand for tobacco

1. INTRODUCTION

1.1 Purpose of the guidelines

Consistent with other provisions of the WHO Framework Convention on Tobacco Control (WHO FCTC) and the decisions of the Conference of the Parties, these guidelines are intended to assist Parties in meeting their objectives and obligations under Article 6 of the WHO FCTC. They draw on the best available evidence, best practices and experiences of the Parties that have successfully implemented tax and price measures to reduce tobacco consumption (the absolute quantity used in the aggregate) and prevalence (the percentage of the population that uses tobacco products).

1.2 Guiding principles

Tobacco use creates a significant economic burden on society at large. Higher direct health costs associated with tobacco-related disease, and higher indirect costs associated with premature loss of life, disability due to tobacco-related disease and productivity losses create significant negative externalities of tobacco use. Taxes not only reduce these externalities through reduced consumption and prevalence but also contribute to governments' expenditures for the health care costs associated with tobacco consumption.

Tax and price policies are widely recognized to be one of the most effective means of influencing the demand for and thus the consumption of tobacco products. Consequently, implementation of Article 6 of the WHO FCTC is an essential element of tobacco-control policies and thereby efforts to improve public health. Tobacco taxes should be implemented as part of a comprehensive tobacco-control strategy in line with other articles of the WHO FCTC.

The following guiding principles underpin the implementation of Article 6 of the WHO FCTC.

(i) Determining tobacco taxation policies is a sovereign right of the Parties

All parts of the guidelines respect the sovereign right of the Parties to determine and establish their taxation policies, in accordance with Article 6.2 of the WHO FCTC.

(ii) Effective tobacco taxes significantly reduce tobacco consumption and prevalence

Effective taxes on tobacco products lead to higher real consumer prices (inflation-adjusted), which lower consumption and prevalence, and thereby in turn reduce mortality and morbidity and improve the health of the population. Increasing tobacco taxes is particularly important for protecting young people from initiating or continuing tobacco consumption.

(iii) Effective tobacco taxes are an important source of revenue

Effective tobacco taxes contribute significantly to State budgets. Increasing tobacco taxes generally further increases government revenues, as the increase in tax normally outweighs the decline in consumption of tobacco products.

(iv) Tobacco taxes are economically efficient and reduce health inequalities

Tobacco taxes are generally considered to be economically efficient as they apply to a product with inelastic demand. Low- and middle-income population groups are more responsive to tax and price increases; therefore consumption and prevalence are reduced in these groups by greater magnitudes than in higher-income groups, resulting in a reduction in health inequalities and tobacco-related poverty.

(v) Tobacco tax systems and structures should be efficient and effective

Tobacco taxes should be structured to minimize compliance costs while ensuring that the desired level of tax revenue is raised and health objectives are achieved.

(vi) Tobacco taxation administrations should be efficient and effective

Efficient and effective administration of tobacco tax systems enhances tax compliance and ensures higher tax revenues while reducing the risk of illicit trade.

(vii) Tobacco tax policies should be protected from vested interests

The development, implementation and enforcement of tobacco tax and price policies should be protected from commercial and other vested interests of the tobacco industry as required under Article 5.3 of the WHO FCTC and the guidelines for its implementation as well as from any other actual and potential conflicts of interests.

1.3 Objectives of the guidelines

The main objective of the guidelines is to assist Parties in developing efficient and effective tax and price policies that meet their needs in terms of reducing tobacco consumption and prevalence, bearing in mind the significance of revenues gained from taxes on tobacco products. Particular emphasis is placed on the fact that tobacco taxation policies may be aimed at reducing the affordability of tobacco products and their consumption mainly by poor and young people. Furthermore, the guidelines will assist Parties in choosing the types of taxes and the products on which tobacco taxes should be levied and in determining the appropriate level and structure of taxes with a view to meeting their national fiscal and public health objectives. An additional objective of the guidelines is to assist Parties in designing tax administration systems that enable them to collect taxes efficiently and effectively, and to raise their awareness of the need to take measures against the illicit trade in tobacco products.

The guidelines provide an overview of representative taxation systems already in place as well as best practices, and include a range of recommendations.

1.4 Scope of the guidelines

These guidelines focus on indirect taxes (excise duties), which affect prices on tobacco products directly. Other taxes or fees, such as income taxes, public fees, and investment encouragement provisions, are not within the scope of these guidelines. Value added tax (VAT) and import duties are briefly described in section 3.1.6.

In a broader perspective, it is important to note that tobacco taxation policies have the ability to directly affect the consumer price of tobacco products and thus reduce consumption, prevalence and affordability. However, tobacco taxes do not exist in a vacuum and should be implemented as part of a comprehensive tobacco-control strategy alongside other policies undertaken in line with other articles of the WHO FCTC, in particular Articles 5 and 7. In that respect, broader economic policy considerations, notably the interrelationship between tax and price policies and employment and income growth, and the consequential social effects on parts of the population, also need to be taken into account. Such an analysis, however, goes beyond the remit of the present guidelines.

The guidelines also consider the impact that illicit and cross-border trade have on taxation policies. When establishing tobacco taxation policies, it is vital to accompany them with all possible measures to eliminate all forms of illicit trade as a main target of tobacco control, in line with Article 15 of the WHO FCTC and the draft protocol to eliminate illicit trade on tobacco products.

2. RELATIONSHIP BETWEEN TOBACCO TAXES, PRICE AND PUBLIC HEALTH

Taxes are a very effective tool for policy-makers to influence the price of tobacco products. In most cases, higher taxes on tobacco products lead to higher prices which, in turn, lead to lower consumption and prevalence and result in a reduction of mortality and morbidity and thus in the improved health of the population.[1] The negative relationship between price and tobacco use has been demonstrated by numerous studies and is not contested.[2]

2.1 Relationship between price and consumption/prevalence (price elasticity)

Taxes and prices affect both the consumption of tobacco products and the prevalence of tobacco use. In high-income countries, evidence suggests that the impact of a price increase is felt approximately half on prevalence and half on intensity (the quantity of tobacco products that a smoker continues to use). Comparable studies in low- and middle-income countries have found similar results.[3]

Any policy to increase real prices (inflation adjusted) through tax rises is effective in terms of reducing tobacco consumption. According to the studies referenced in the *WHO technical manual on tobacco tax administration*, the relationship between prices and tobacco consumption is inelastic, meaning that the decline in consumption is less than proportional to the increase in price. This relationship is defined by the price elasticity of demand, or the percentage change in consumption as a result of a

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[1] *Price and tax policies (in relation to Article 6 of the Convention): technical report by WHO's Tobacco Free Initiative*. Report to the fourth session of the COP, Punta del Este, Uruguay, 2010 (document FCTC/COP/4/11): paragraph 4. Available from: http://www.who.int/fctc/publications/en/.

[2] See for example *WHO technical manual on tobacco tax administration*. Geneva, World Health Organization, 2010: Chapter 1.

[3] *WHO technical manual on tobacco tax administration*. Geneva, World Health Organization, 2010: Chapters 1 and 2.

1% change in price. For example, if the price elasticity of demand is -0.5, a 10% increase in price will result in a 5% decrease in consumption. Most estimates of the price elasticity of demand lie between -0.2 and -0.8.[1]

In all settings, studies have shown that the price elasticity of demand is higher (in absolute terms) in the long term, meaning that consumption will fall even more in the long term. People with lower socioeconomic status are more responsive to tax and price changes because such changes have a greater impact on their disposable income.

As regards the effect of higher taxes and prices on the tobacco use by young people it is estimated that young people are two to three times more responsive to tax and price changes than older people.[2] Therefore, tobacco tax increases are likely to have a significant effect on reducing consumption, prevalence and smoking initiation among young people, as well as on reducing the chances of young people moving from experimentation to addiction.

Equally important, higher taxes reduce the demand for tobacco most sharply in low- and middle-income population groups or in countries where tobacco users are more responsive to price increases, thereby contributing to the fight against health inequalities.

An increase in tax rates usually leads to an increase in revenues earned by governments. Since tobacco products are price inelastic, the increase in tax can be expected to be proportionally larger than the decline in consumption, meaning that revenues increase as a result of tax increases. However, it is theoretically possible that at some point tax increases could result in declining revenue as tobacco products become price elastic (meaning that the decline in consumption is more than proportional to the increase in price). However, very few countries in the world, if any, are anywhere near this point.

2.2 Taxation and affordability (income elasticity)

Affordability is generally defined as the cost of tobacco products in relation to income per capita. Trends in affordability and income elasticity of demand need to be estimated using appropriate modelling techniques. Most such affordability estimates are currently based on cigarettes.

A study carried out by the School of Economics, University of Cape Town, South Africa, appears to show that cigarette affordability, rather than simply price, is a critical determinant of cigarette consumption. Therefore, an effective policy aiming at reducing tobacco consumption needs to take into account both price and income level developments.[3]

Increases in income result in increasing tobacco consumption and prevalence, particularly in low- and middle-income countries. The income elasticity of demand is the percentage change in consumption as a result of a 1% change in income. Most estimates of income elasticity of demand for tobacco products

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[1] *Effectiveness of tax and price policies for tobacco control* (IARC Handbooks of Cancer Prevention: Tobacco Control. Volume 14). Lyon, International Agency for Research on Cancer, 2011.

[2] *Price and tax policies (in relation to Article 6 of the Convention): technical report by WHO's Tobacco Free Initiative*: paragraph 7.

[3] Blecher EH, van Walbeek CP. An international analysis of cigarette affordability. *Tobacco Control*, 2004, 13:339–346.

lie between 0 and 1. An income elasticity of demand of 0.5 means that an increase in income of 10% will result in tobacco consumption rising by 5%.[1]

Without price increases above the growth in income, tobacco products will inevitably become more affordable over time. This increase in affordability will result in growing consumption. Evidence suggests that tobacco products are becoming more affordable in low- and middle-income countries and that this increase in affordability has accelerated in recent years.[2] Instead, in high-income countries tax and price increases have generally outpaced growth in incomes, which has resulted in a decline in the affordability of tobacco products since 1990.

Some countries have chosen to implement tax systems and structures that lessen the impact of tobacco taxes on the poor. However, by doing so they make tobacco products more affordable to the poor, thereby raising their consumption and prevalence, resulting in a disproportionately high burden of health and economic costs on the poor and higher inequalities in health. Furthermore, tobacco use may increase poverty by diverting expenditure away from necessities like food, housing, education and health care. Since the poor are more responsive to tax and price increases, increases in taxes are likely to reduce their consumption and prevalence by greater magnitudes than among the rich, resulting in a reduction in health inequalities and tobacco-related poverty.[3]

The tax structure can also contribute to making tobacco products generally less affordable, mainly among the most vulnerable segments of the population, by diminishing the differences between higher and lower prices and reducing the price range.

Recommendation

When establishing or increasing their national levels of taxation Parties should take into account – among other things – both price elasticity and income elasticity of demand, as well as inflation and changes in household income, to make tobacco products less affordable over time in order to reduce consumption and prevalence. Therefore, Parties should consider having regular (automatic) adjustment processes or procedures for periodic revaluation of tobacco tax levels.

3. TOBACCO TAXATION SYSTEMS

3.1 Structure of tobacco taxes (ad valorem, specific, mixture of both, minimum taxes, other taxes on tobacco goods)

Almost all governments levy taxes on tobacco products, although they use a variety of types of taxes in order to achieve a reduction in tobacco consumption and stable government revenues. In most cases, tobacco products are taxed on a national basis with the same tax levels applied in all areas of the country (national or federal taxes). However, a small number of countries have additional sub-national

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[1] *Price and tax policies (in relation to Article 6 of the Convention): technical report by WHO's Tobacco Free Initiative*: paragraph 4.

[2] Blecher EH, van Wallbeek CP. Cigarette affordability and trends: an update and some methodological comments. *Tobacco Control*, 2009, 18:167–175.

[3] John RM et al. *The economics of tobacco and tobacco taxation in India*. Paris, International Union Against Tuberculosis and Lung Disease, 2010; John RM. Price elasticity estimates for tobacco in India. *Health Policy and Planning*, 2008, 23(3): 200–209; Nargis N et al. (forthcoming). *Chapter on poverty.* NCI/WHO monograph on the economics of tobacco and tobacco control.

(regional and sub-regional) taxes applied on a state or provincial level. Generally speaking, co-existing layers of tobacco taxes create greater complexity and reduce the overall efficiency of tax systems.

Tax systems can be made up of purely specific or ad valorem taxes. However, mixed or hybrid systems using a mix of both specific and ad valorem taxes can be applied. Examples of such systems include an ad valorem tax with a specific floor (minimum amount of tax) and a mixed specific and ad valorem excise with or without a tax floor. Generally, the more complex a system is designed the more difficult it is to administer.

3.1.1 Types of taxes

In general, taxes levied specifically on tobacco products are excise duties while other non-tobacco related taxes including general sales tax (GST), VAT and import taxes/duties may also be levied on tobacco products. An excise duty is a tax levied on the sale or production for sale of a specific product within a country but normally not on products produced in a country for sale abroad (exported). An excise tax may be *specific* (a fixed amount based on a quantity, such as number of cigarettes per pack, or weight) or *ad valorem* (a percentage of value). As any other excise duties tobacco excises are a tool to raise the price of the targeted product in relation to other goods or services and are relatively easy to administer as they are collected early in the production chain.

3.1.2 Specific excise duty

Specific taxes can either be set as a uniform specific tax, which levies the same value on all concerned products, or at variable rates, setting different values on different products. Uniform specific taxes are generally considered to be a price floor (minimum tax) since it becomes generally impossible to set the price below the specific tax.

A single uniform specific tax represents a simple and easy model to implement and administer and it is simple to understand for citizens. Greater reliance on specific duties can lead to further approximation of retail selling prices within a region. Furthermore, as they are based on consumption volumes rather than on prices, such taxes are more stable, easier to forecast and to administer, increase the stability of tax revenues and guarantee tax revenue independent of industry price strategies.

The administrative burden of collecting a uniform specific tax is low because only the volume, and not the value, of the product needs to be ascertained (e.g. pieces or kilograms released for consumption). However, the real value of the tax will be eroded unless it is regularly increased at least in line with inflation. Therefore, specific tax systems may be strengthened by linking the taxes to an appropriate consumer or retail price index in order to reduce the impact of inflation.

Furthermore, uniform specific taxes tend to lead to relatively higher prices, even on low-priced products, and can result in an upgrading effect since consumers are more likely to switch to higher-priced brands or less likely to switch to lower-priced brands given that the relative price differences between lower- and higher-priced brands will be smaller. As a consequence, the manufacturers' margins are higher for expensive brands. Lower-priced products do not provide such margins as they need to be cheaper than the high-priced brands in order to maintain their competitiveness.

3.1.3 Ad valorem excise duty

Ad valorem duties are expressed as a percentage of a certain base value, which is applied either on the retail selling price (containing all applicable taxes) or the manufacturer's (or ex-factory) or cost insurance freight (CIF) price.

Ad valorem taxes have the advantage of automatically maintaining their value with inflation without any adjustment in the tax rates. They will also maintain the relative price differentials between high and low priced products, as both are taxed in a comparable way. This comparable treatment of all market players (in the low and the high price segment) may however lead to more price competition and consequently to a lower average price.

On the other hand, ad valorem tax systems require the calculation of a second tax base figure: besides the volume of the release for consumption, the value of all products of a certain price category must be determined in order to calculate the applicable tax amounts. Pure ad valorem systems may also be susceptible to product undervaluation in order to reduce the taxable value of products, mainly if ex-factory or CIF price is used as the tax base. Furthermore, pure ad valorem systems can encourage bigger price differences between different products. This could lead to consumers buying cheaper products only. Reductions in the retail price will also reduce the value of tax meaning that the government’s revenue declines.

These problems can be averted by implementing a minimum (specific) tax floor (see section 3.1.5), although the producers, wholesalers or distributors benefit from such a construct as a clearly determined minimum tax has to be paid by all market players selling the same product. In addition, the government’s revenues benefit in the same way, as a certain minimum amount of tax income is guaranteed (all producers, wholesalers or distributors will need to pay that minimum tax amount regardless of the retail selling price of the product).

3.1.4 Mixture of specific and ad valorem excise duty

As a third category of excise duty structure, governments can apply a mixture of both specific and ad valorem excise duties.

The choice of excise(s) applied by countries varies by income group and by region. In general, low-income countries are more likely to lean towards an ad valorem excise: in contrast, high-income countries are more likely to lean towards a specific excise. For middle-income countries, the picture is less clear.

Mixed systems usually combine a specific tax to all brands, which has more impact on lower-priced brands (through a minimum specific tax floor) and an ad valorem tax having more impact on higher-priced brands. This contributes to a balanced taxation of all brands and to a level playing field among manufacturers.[1]

In a mixed system, the emphasis placed by each country on either the ad valorem or the specific element depends on national circumstances and the policy objectives being pursued. While the ad valorem component increases absolute price differences and consequently promotes cheaper brands of cigarettes – which can undermine health-driven price policy objectives – the specific component reduces the relative price differences between cheap and expensive brands and contributes to minimizing the variability of prices.

In order to guarantee that the balance between the ad valorem and specific components in such a mixed tax structure is not undermined by the implementation of a high (specific) minimum excise duty, a limitation of the share of the specific component vis-à-vis the ad valorem component is

[1] EU legislation, recognizing the health objectives of tobacco excises, prescribes such a mixed system. See: http://ec.europa.eu/taxation_customs/taxation/excise_duties/tobacco_products/legislation/index_en.htm.

generally considered to be the most appropriate proceeding (e.g. the specific component could be set at between 10% and 75% of the total tax including VAT). This ensures that the ad valorem part of the tax rate continues to be effective within a mixed structure.

A mixed system can also help to prevent a situation of purely specific taxation in one country and purely ad valorem taxation in a neighbouring country, which would result in cross-border flow of premium (expensive) brands from one country to a second one with cheap brands flowing in the other direction.

A mixed excise structure consisting of a specific and an ad valorem component combined with a compulsory minimum excise duty provides, in such circumstances, for a well-balanced, fair tax architecture, while maintaining a high level of flexibility for the authorities concerned. For that reason, implementing such a mixed system presents undeniable advantages in order to benefit from its combined effects.

3.1.5 Systems with minimum rates

To address the susceptibility of products to undervaluation in order to reduce their taxable value, a minimum tax level expressed as a fixed amount (a minimum specific tax floor) can be applied in ad valorem systems or in mixed systems (see section 3.1.4) consisting of an ad valorem and a specific tax rate. Purely specific excise rate systems will never have such a minimum floor.

The application of a minimum specific tax floor on all tobacco goods of a product category ensures a certain minimum amount of excise duties to be paid by the manufacturers, regardless of the retail selling price of the product. In some countries, minimum prices are used for the same purpose. As a consequence, a certain revenue income is guaranteed even if tobacco goods are levied with an ad valorem excise rate only.

The ad valorem part of the excise duty provides for a tax progression above the specific minimum tax floor, which prevents high-priced brands from “escaping” a higher tax burden. Furthermore, an increase in the minimum duties will decrease the gap between the cheapest and most expensive tobacco products.

At regional level, positive experience has been gained by making wide use of a mixed system with minimum rates (specific and ad valorem) and, where appropriate, the possibility of applying individual national minimum rates. With regard to cigarettes, for example, EU Member States apply a mixed excise duty system including a specific and an ad valorem component and almost all impose a national minimum tax floor. Fixed minimum amounts are applicable across the EU.[1]

3.1.6 Other taxes on tobacco products

Other taxes that are not levied specifically on tobacco products are not within the scope of these guidelines. Although they are applied to tobacco products and have a significant impact on prices, they are not considered to be of significant value to public health since all potential substitutes are likely to have the same or similar taxes/tax rates. This is particularly the case with GST and VAT, which are normally ad valorem taxes. Import duties/tariffs are a similar case, even though these duties can be

[1] In the EU, cigarette excise duties must currently account for at least 57% of the retail selling price, inclusive of all taxes, and be at least €64 per 1000 cigarettes based on the weighted average price. The specific component of excise duty must not be less than 5% or more than 76.5% of the total tax share in the final price of cigarettes.

levied at differential rates on tobacco products. They have variable ability to raise the prices of tobacco products and are always levied as an ad valorem tax with the same advantages and disadvantages as those mentioned above.

Recommendation

Parties should implement the simplest and most efficient system that meets their health and fiscal needs, with the fewest exceptions and taking into account their national circumstances. From a budgetary as well as a health point of view, Parties should implement specific or mixed excise systems with a minimum specific tax floor, as these systems have considerable advantages over purely ad valorem systems.

3.2 Level of tax rates to apply

It is difficult to prescribe the optimal level for taxes because of differences in tax systems, in geographical and economic circumstances, and in national public health and fiscal objectives. The amount of excise duty on cigarettes as a percentage of the retail selling price (RSP) differs enormously around the world, from an average of 25% excise share in the RSP in low-income countries up to an average of 60% in high-income countries.[1] From a regional perspective the gap is even bigger: from 0% excise duty in 19 out of 182 countries that provided data (mostly from the WHO African and South-East Asia Regions) up to an average of 62.61% in the EU (with a peak of 73.47% excise duty in the RSP leading to a total tax share of 90.14%).[2] As regards tobacco products other than cigarettes, the range of applied excise duty levels is similarly wide.

Low excise levels in the RSP, as well as large gaps within regions or between neighbouring countries, have a number of negative effects such as cross-border flows and increasing illicit trade, leading to loss of revenues and damage to public health policies.

As mentioned above, the fixing of a benchmark depends on various factors, in particular national and regional political and economic factors. In this regard, authors of the World Bank and WHO have made recommendations on the percentage of excise duties and total tax share in the RSP.[3]

Where appropriate, a regional approximation (increase) of tax rates, in particular as regards the percentage of taxes in the RSP, leading to an approximation of retail prices, would reduce incentives to conduct illicit trade and cross-border shopping and thus ensure stable revenue generation. The same applies to a further approximation of tax rates and retail prices levied on different tobacco product categories (see also section 3.3).

When it comes to the most effective calculation base for excise duties on tobacco products – in particular cigarettes – the concept of the "most popular price category" (MPPC) as the RSP should be altered in favour of the "weighted average price" (WAP) of all cigarettes. In most regions, national

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[1] Data obtained from *WHO report on the global tobacco epidemic, 2009: Implementing smoke-free environments.* Geneva, World Health Organization, 2009. Available from: http://www.who.int/tobacco/mpower/2009/en/index.html.

[2] *WHO technical manual on tobacco tax administration.* Geneva, World Health Organization, 2010: Chapter 2; *2010 global progress report on implementation of the WHO FCTC.* Geneva, World Health Organization, 2010: page 9; European Commission, Excise Duty Tables part III, July 2011. Available at: http://ec.europa.eu/taxation_customs/taxation/excise_duties/index_en.htm.

[3] *WHO technical manual on tobacco tax administration.* Geneva, World Health Organization, 2010: Chapter 2.6; *Curbing the epidemic: Governments and the economics of tobacco control*, Washington, DC, World Bank, 1999.

markets are no longer dominated by one most popular “national” brand. In comparison with the MPPC, which is determined on the basis of the most-sold brand or a specific price category on a national market in a certain period of time, the WAP as RSP covers all cigarettes/tobacco products released for consumption. This provides more transparency, a fair and well-balanced tax rate determination and creates a level playing field across the tobacco sector.[1]

Recommendation

Parties should establish coherent long-term policies on their tobacco taxation structure including targets for their tax rates, in order to achieve their objectives within a certain period of time. Tax rates should be monitored and increased on a regular (potentially annual) basis in order to take into account inflation and income growth developments. Regional particularities (e.g. cross-border trade) should be taken into account when formulating these policies.

3.3 Comprehensiveness/similar tax burden for different tobacco products

There is a wide variation in the types of tobacco products used in different parts of the world. Although much of the experience of Parties with respect to taxation of tobacco products refers specifically to manufactured cigarettes, Parties should recognize the need for a tax policy on all tobacco products. Furthermore, systems should be simplified and harmonized to ensure that different products are taxed with the same goals in mind.

Different rates of taxation on different tobacco product categories (e.g. manufactured cigarettes versus roll-your-own tobacco) or within similar product categories (e.g. high-priced versus low-priced cigarettes) can create incentives for users to switch between product categories or use products originating in the illicit trade chain. Higher rates on one product relative to another may encourage users to switch to the lower-taxed and thus cheaper products.

The expected decrease in consumption can thus be mitigated by a switch to other tobacco products (substitution effect) and an increase in circumvention. For example, as regards cigarettes, fine-cut tobacco and cheap cigarettes are generally the main alternative products for consumers in case of significant price increases for cigarettes. In such cases, while higher taxes usually result in a reduction of tobacco consumption, the effect of tax increases may be weakened by substitution of expensive tobacco products by other tobacco products or a switch to cheaper categories of cigarettes and to discount brands.

Recommendation

In order to avoid negative consequences, such as product substitution or an increase in illicit trade as well as to ensure that health objectives are met, all tobacco products should be taxed in a comparable way, where appropriate with a similar tax burden, and should be accompanied by strong policies and measures against illicit trade in tobacco products.

Parties should ensure that tax systems are designed in a way that does not encourage users to shift to cheaper products in the same product category or to cheaper tobacco product categories as a response

[1] The WAP can be calculated as follows: total value of all cigarettes released for consumption (RSP inclusive of all taxes) divided by the total quantity of cigarettes released for consumption in a determined period of time (e.g. one year). See also European Commission, Excise Duty Tables part III, July 2011.

to tax increases. In particular, the tax burden on other tobacco products should be increased and, where appropriate, be similar to the tax burden on cigarettes.

4. TAX ADMINISTRATION

This section provides information and recommendations on effective administration of tobacco excise tax systems.

4.1 Authorization/licensing

The primary control in an effective tobacco tax administration is to identify all entities which are required to pay taxes and the extent of their tax liability. Common tax compliance measures require all producers, importers, warehouse keepers and exporters of tobacco products to apply for authorization, licensing or registration with tax authorities, to file regular tax returns and to make regular payments of taxes as specified in tax laws.[1]

Licences, registrations or authorizations are issued subject to conditions and with the ability to be amended, revoked or cancelled for non-compliance.

In countries with a large number of informal retailers licensing may be difficult. However, exceptions should be kept to a minimum.

Recommendation

Parties should ensure that transparent licence or equivalent approval or control systems are in place.

4.2 Warehouse system/movement of excisable goods and tax payments

Since controls need to be carried out in production and storage facilities in order to ensure that the tax debt is collected, it is necessary to maintain a system of warehouses, subject to authorization by the competent authorities, for the purpose of facilitating these controls. Many countries oblige and authorize natural or legal persons (as authorized warehouse keepers) to produce, process, hold, receive and dispatch products subject to excise duty in the course of their businesses, under suspension of the excise duty. Guarantees can be requested from warehouse keepers to secure the payment of taxes. Features of such a system may include: strict criteria for granting authorization; warehouse pre-authorization visits; adequate stock control measures; checking the origin of excise products and the entire production process; and coding and marking products. Monitoring movements of excise goods under suspension of excise duty via a computerized system can also be used as a control tool.[2]

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[1] The Organisation for Economic Co-operation and Development (OECD) notes that comprehensive systems of taxpayer registration and numbering are a vital feature of the tax administration arrangements in most countries, supporting most tax administration processes and underpinning all return filing, collection and assessment activities. See: *Tax administration in OECD and selected non-OECD countries: Comparative information series (2008).* Available from: http://www.oecd.org/document/36/0,3746,en_2649_33749_42174884_1_1_1_1,00.html.

[2] In all EU countries, a computerized excise movement and control system is in place (EMCS), supporting all processes of warehouse and movement requirements. See: http://ec.europa.eu/taxation_customs/taxation/excise_duties/ circulation_control/index_en.htm.

Recommendation

Parties should maintain a system of storage or production warehouses to facilitate excise controls. In order to reduce the complexity of tax collection, excise taxes should be collected at the point of manufacture, importation or release for consumption from the storage or production warehouse.

Tax payments should be required by law to be produced at fixed intervals or on a fixed date each month and should ideally include reporting of production and sales volumes, taxes due and paid, and volumes of raw material inputs.

Tax authorities should also allow for the public disclosure of reports, taking into account confidentiality rules.

4.3 Anti-forestalling measures

In some cases, changes to taxes can be anticipated by manufactures or importers. This may be because taxes are indexed to inflation or known benchmarks. In anticipation of tax increases, manufacturers or importers may attempt to take advantage of the current or lower tax and increase production or stock of products (known as forestalling).

To prevent this from occurring, and to ensure that authorities receive the extra revenue from tax increases, rather than producers or importers, Parties should consider implementing anti-forestalling measures, such as:

- restricting the release of excessive volumes of tobacco products immediately prior to a tax increase;
- taxing products already produced or kept in stock before a tax increase;
- levying the new tax on all products not yet supplied to the final consumer, including those in retail (known as a floor-stock tax).

Recommendation

In anticipation of tax increases Parties should consider imposing effective anti-forestalling measures.

4.4 Fiscal markings/tracking and tracing

Using fiscal markings is generally considered to be an appropriate tool to increase compliance with tax laws through monitoring of production and importation. Moreover, fiscal markings can help in distinguishing between illicit and legal tobacco products. Markings include tax stamps, enhanced tax stamps (also known as banderols) and digital tax stamps.

Fiscal markings are usually applied at the pack level at specified positions on the pack. Setting a certain standard pack size facilitates the application of fiscal markings and increases the efficiency of tax administration. In line with Article 15 of the WHO FCTC, the development of a tracking and tracing system including marking of tobacco products with a unique identifier may further secure the distribution system and assist in investigations of illicit trade.

Recommendation

Where appropriate, Parties should consider requiring the application of fiscal markings to increase compliance with tax laws.

Parties should, as appropriate, require a tracking and tracing system to be in place in line with Article 15 of the WHO FCTC.

4.5 Enforcement

Effective tobacco tax administration requires clear designation of responsible enforcement authorities. Tax authorities should generally have the authority and capacity to conduct search, seizure, retention and disposal activities in line with those of law enforcement agencies, and should be provided with necessary enforcement tools including appropriate technologies. In addition, the sharing of information among enforcement agencies is also a helpful feature for efficient enforcement in accordance with national laws.

Penalties for non-compliance with tax laws usually include suspension or cancellation of licence or the application of more stringent conditions on the licence, fines and/or jail, forfeiture of products, forfeiture of equipment used in the manufacture or distribution of products including machinery and vehicles, cease and desist orders, and other administrative remedies as appropriate. Penalties and interest are applied to the late payment of taxes, and back taxes and punitive taxes are applied to the non-payment of taxes.

Recommendation

Parties should clearly designate and grant appropriate powers to tax enforcement authorities.

Parties should also provide for information sharing among enforcement agencies.

In order to deter non-compliance with tax laws, Parties should provide for an appropriate range of penalties.

5. USE OF REVENUES – FINANCING OF TOBACCO CONTROL

According to Article 6.2 of the WHO FCTC, Parties shall retain their sovereign right to determine and establish their taxation policies. An integral part of each Party’s sovereign right is to decide how the revenue stemming from tobacco taxation is used.

As already noted in the guidelines for implementation of Articles 8, 9 and 10, 12, and 14,[1] tobacco excise taxes provide a potential source of financing for tobacco control. Parties could consider, while bearing in mind Article 26.2 of the WHO FCTC, dedicating the revenues from tobacco taxation or part of it to tobacco-control programmes, such as those covering awareness raising, health promotion and disease prevention, cessation services, economically viable alternative activities, and financing of appropriate structures for tobacco control.

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[1] The guidelines are available at: http://www.who.int/fctc/protocol/guidelines/adopted/en.

6. TAX-FREE/DUTY-FREE SALES

In duty-free shops in airports, on international transport vehicles and in tax-free shops, tobacco products are sold often without any excise tax burden. Generally, tax- or duty-free sales in airports or in other designated places apply to travellers who will take the tobacco products out of the country and are exempted from the payment of certain local or national taxes and duties. Tax- or duty-free sales are thus regarded as some kind of exportation and therefore these sales are not taxed as a matter of principle. However, in some countries, travellers can also buy from duty-free shops in airports not only when leaving but also when entering the country.

Tax- and duty-free sales erode the effects of tax and price measures aimed at reducing the demand for tobacco products, since tax-free tobacco products are cheaper and more affordable than those which are taxed. This is counterproductive to the health purpose behind taxation and harms public health by encouraging personal consumption. Moreover, these sales adversely affect government revenues by creating a loophole in the tax structure. In particular, tax- or duty-free shops at land borders can be the origin of illicit supplies of tax-or duty-free cigarettes to final consumers. There is growing evidence that governments are taking action to prohibit or restrict tax- or duty-free sales.

Article 6 of the WHO FCTC states that each Party should “adopt or maintain, as appropriate, measures which may include […] prohibiting or restricting, as appropriate, sales to and/or importations by international travellers of tax- and duty-free tobacco products”. While it is up to the Parties to consider taking these measures, a distinction between the specificities of land, air and sea travel might be needed, in particular a distinction between border shops and duty-free points of sale.

International actions to ban tax- or duty-free sales are built around three basic options:

- prohibiting tax- or duty-free sales of tobacco products;
- applying excise taxes on tobacco products sold in tax- or duty-free stores; or
- limiting travellers’ allowances for tobacco products to restrict private imports of tax- or duty-free tobacco products, such as by applying quantitative limits.[1]

Recommendation

Parties should consider prohibiting or restricting the tax- or duty-free sales of tobacco products. They should monitor the extent to which tax- or duty-free products contribute to illicit trade and take the necessary measures if such a link is ascertained.

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[1] For example, the EU applies quantitative limits for travellers entering one of the EU’s Member States from a non-Member State. Each Member State may choose to apply quantitative limits for tobacco products according to the following rules:

- Cigarettes: 200 or 40 pieces per traveller older than 17 years of age;
- Cigarillos: 100 or 20 pieces per traveller older than 17 years of age;
- Cigars: 50 or 10 pieces per traveller older than 17 years of age;
- Smoking tobacco: 250 grams or 50 grams per traveller older than 17 years of age,

whereas cigarillos are cigars of a maximum weight of 3 grams each.

7. ILLICIT TRADE

The primary reference in regard to illicit trade in tobacco products is Article 15 of the WHO FCTC.

Illicit trade makes tobacco products more available and affordable, undermining tobacco taxation and health policies. By making artificially "cheap" cigarettes readily available through unregulated sales channels, illicit trade increases the prevalence of smoking and tobacco consumption, primarily among the young, the poor and populations in low- or middle-income countries.

Illicit trade undermines tobacco tax collection and administration, especially in countries applying high taxes.

According to the tobacco industry, tax increases cause illicit trade. However, numerous countries have raised tobacco taxes effectively and have experienced revenue increases without experiencing a dramatic rise in smuggling.[1] The relationship between taxes/prices and illicit trade largely depends on the existence of corruption and/or the ease with which legal controls may be circumvented.[2] Therefore, when countries increase tobacco taxes, they should also strengthen their tax enforcement and tax administration.

It is empirically proven that taxes and prices are not the main cause of illicit trade. Price is only one of many factors that may influence illicit trade.[3]

Recommendation

When implementing Article 6 of the WHO FCTC, Parties should take necessary measures to contain the risk of illicit trade, consistent with their obligations under Article 15 of the WHO FCTC.

8. INTERNATIONAL COOPERATION

International cooperation in scientific and legal fields, provision of related expertise, and exchange of information and knowledge are important means of strengthening the capacity of Parties to meet their obligations under Article 6 of the WHO FCTC. Such measures should be in line with the commitments that Parties have undertaken with respect to international cooperation, particularly under Articles 4.3, 5.4, 5.5, 20 and 22 of the WHO FCTC.

According to Article 21 of the WHO FCTC, the periodic reports of the Parties represent another important tool for international exchange and collaboration under the Convention. Article 6 of the WHO FCTC stipulates that the Parties shall provide rates of taxation for tobacco products, ideally including the relative and absolute tax burden, and trends in tobacco consumption in their periodic reports, in accordance with Article 21.

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[1] *Illicit tobacco trade – Illegal profits and public peril.* Campaign for Tobacco-Free Kids, 2008: pages 5–6. Available from: http://www.tobaccofreecenter.org/files/pdfs/en/ILL_overview_en.pdf.

[2] Merriman D. *Understand, measure and combat tobacco smuggling.* Washington, DC, World Bank, 2002: pages 8–9. Available from: http://siteresources.worldbank.org/INTPH/Resources/7Smuggling.pdf.

[3] *Tobacco smuggling.* Fact sheet provided at the 11th World Conference on Tobacco OR Health, 6–11 August 2000. Available from: http://www.ash.org.uk/files/documents/ASH_232.pdf.

Generally, as a basis for any policy and regulatory measures, transparent and sufficiently comprehensive data are needed. The relevant international organizations play an important role in the collection, compilation and publication of such data. Parties should also consider reviewing the reports of other Parties, and the data and trends deriving from global progress reports presented to each regular session of the Conference of the Parties, to enhance their knowledge of international experiences with respect to tax and price policies.

International cooperation would also help to ensure that consistent and accurate information related to global, regional and national trends and experiences in relation to tax and price policies is provided, particularly through the global treaty implementation database maintained by the Convention Secretariat.

Parties should also consider utilizing the multisectoral dimension of tax and price policies and cooperating within relevant bilateral and multilateral mechanisms and organizations to raise awareness and to promote the implementation of relevant policies.

Parties should cooperate in reviewing and, if necessary, updating these guidelines, according to a mechanism and timeline to be established by the Conference of the Parties, to ensure that they continue to provide effective guidance and assistance to Parties in establishing their tax and price policies with respect to tobacco products.

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