

IMPROVING TOBACCO TAXATION POLICIES IN SOUTHEASTERN EUROPE

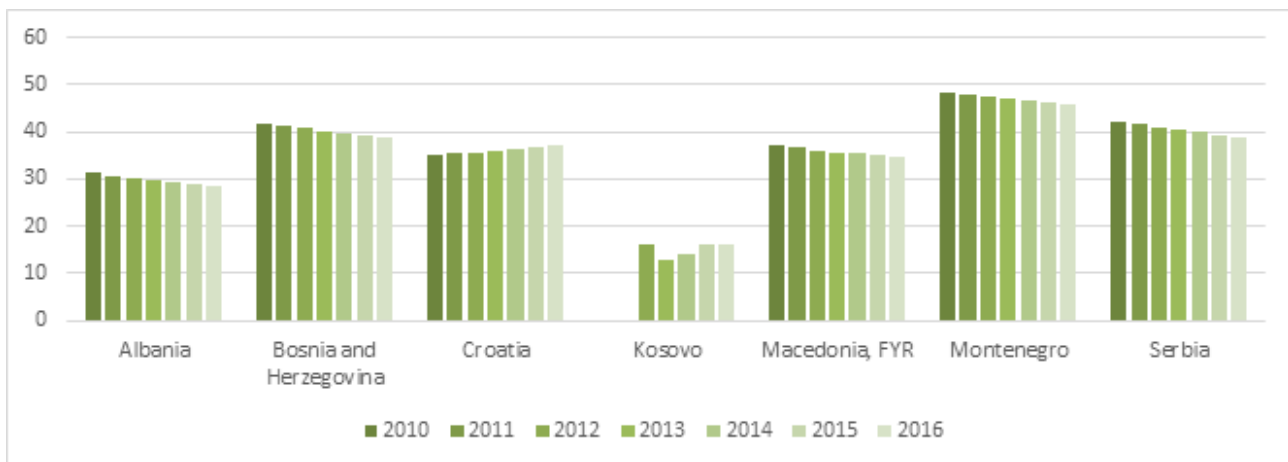
INTRODUCTION

All seven Southeastern European (SEE) countries (**Albania, Bosnia and Herzegovina (B&H), Croatia, Kosovo, Macedonia, Montenegro, and Serbia**) have ratified the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) recognizing taxes as an effective tool for reducing the use of tobacco products. Although some positive effects of excise tax increases on tobacco consumption can be seen over the last few years, it seems that other determinants of demand (such as industry marketing) have offset its real impact on tobacco prevalence. **Research from the seven SEE countries** suggests there is a significant potential for accelerating the increase of excise duties to reduce the negative effects of tobacco consumption on public health and the economy. As shown in

Figure 1, **current prevalence rates in SEE are still high**, with rates in Montenegro being the highest (45.9%) and Albania being the lowest (28.7%). It is also higher in comparison to the EU member countries, where the European Health Survey reports an average rate of daily smokers of 18.4%.

Current tobacco taxation policies in SEE rely on **gradual tax increases** aimed at ensuring stable and predictable fiscal revenues. Despite high prevalence, even among youth, **very little effort has been made in the region as a whole to highlight the negative health and economic impacts of tobacco consumption**. The effectiveness of tobacco control strategies, including tobacco taxation, is—to a large extent—missing from the policy and research agendas of local stakeholders.

Figure 1: Smoking prevalence in the region (in %)



Source: World Bank, World Development Indicators, except for Kosovo and Macedonia

RELATIONSHIP BETWEEN GOVERNMENT AND TOBACCO INDUSTRY

When creating taxation policy, **policy-makers in the region have been facing “false trade-off” arguments**. On the one hand, they have an incentive to increase excise duties as higher excises have proven to have a positive impact on fiscal revenues over the last decade. On the other hand, they are facing persistent arguments made by the tobacco industry that higher taxes would lead to a higher volume of illicit trade and to a decrease in employment. These arguments against higher taxes have been reinforced by industry’s claims that they are a very important source of tax revenues, and are generous investors, major

employers, exporters, and “socially responsible” government partners. This is particularly true in Serbia, where three of the four largest multinational tobacco companies have enhanced their production facilities with strong and open support from the Serbian Government. Industry argues that increases in excises will result in the explosion of illicit trade and subsequent layoffs, as well as a decrease in fiscal revenues. Recently, such lobbying activities have been particularly noted in B&H and Montenegro, where industry is trying to block tax reforms. However, these arguments are not supported by research evidence from around

the world. Firstly, taxes on tobacco have proven to be very effective at generating additional public revenues. Secondly, tax increases, as a tool of tobacco control, do not harm economies in any other aspect. They do not lead to net job loss as the rise of other economic sectors more than offsets the potentially negative labor market effects of reduced tobacco consumption. Thirdly, the rise of illicit trade is an issue of institutional deficiency rather than a consequence of the lower affordability of tobacco products, a fact which has been also confirmed in the experiences of other countries, such as the UK.

Research conducted by the project **“Accelerating Progress on Effective Tobacco Tax Policies in Low and Middle-Income Countries”** confirms that increasing in excise taxes results in a simultaneous decrease in tobacco consumption and increase in fiscal revenues. These results suggest that **governments should change the current policy approach to opt for a more aggressive tax increase**, i.e. price shocks from an increase of the specific excise component. Findings clearly confirm that policymakers in the region should abandon the “false trade-off” arguments and should rather support strong institutions to ensure tax increases secure significant increases in revenues and other economic and health benefits.

Even when positive effects of decreased prevalence (such as savings within the healthcare system, increases in productivity, and stronger development of other economic sectors) are ignored, higher taxation of tobacco has positive effects on a society. Higher taxation can open significant fiscal space for funding of development spending on education, infrastructure, the overall healthcare system, and toward achieving the Sustainable Development Goals (SDG) and other public services (including tobacco control activities).

Tobacco policy in SEE has not been formulated with unbiased scientific results. Decision-makers in the region are still focused on particular policy effects, failing to analyze the whole picture and overall societal benefits. As with any policy issue, analyzing tobacco taxation and tackling tobacco consumption requires the collection of adequate data, transparency, and coordination amongst policymakers. Unfortunately, the current situation in the SEE has been characterized by strictly divided policy departments which rarely cooperate with each other (Ministries of Finance, Health, Trade, etc.), weak implementation of strategies, and lack of transparency with the data, all of which limit research efforts necessary to analyzing issues relevant to policy.

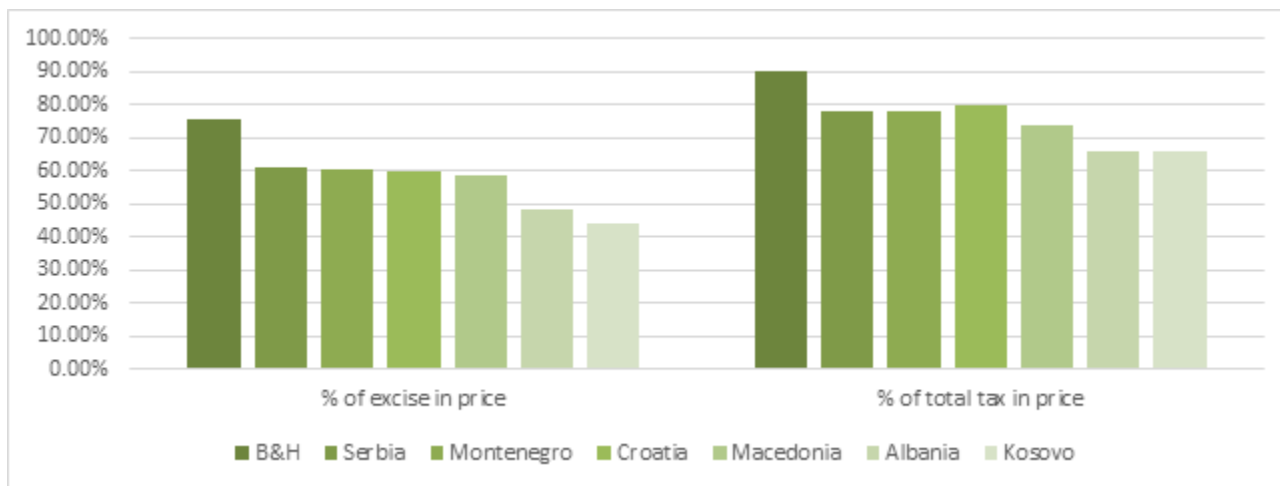
CURRENT TAXATION POLICY AND PRICING OF TOBACCO PRODUCTS

Except for Albania and Kosovo, which levy only a specific excise tax, the excise tax systems in other SEE countries are **mixed, consisting of a specific and an ad-valorem excise tax**. The highest excise and tax burden is registered in B&H, (76% and 91% of the weighted average retail sales price (RSP), respectively), followed by Croatia, Montenegro, and Serbia with an excise share of around 61% and an overall tax share of close to 80% of the weighted average price of cigarettes (Figure 2). Apart from B&H, none of the excise tax policies of the other SEE countries are currently in line with the WHO benchmark of 70% of the excise share in RSP. However, it should also be noted that the RSPs in

B&H are among the lowest in the region. When it comes to the EU regulations, Albania and Kosovo still do not fulfil either of the two recommendations, while all the observed countries are still far below the second EU criteria of EUR 90 of the excise tax on 1000 cigarettes.

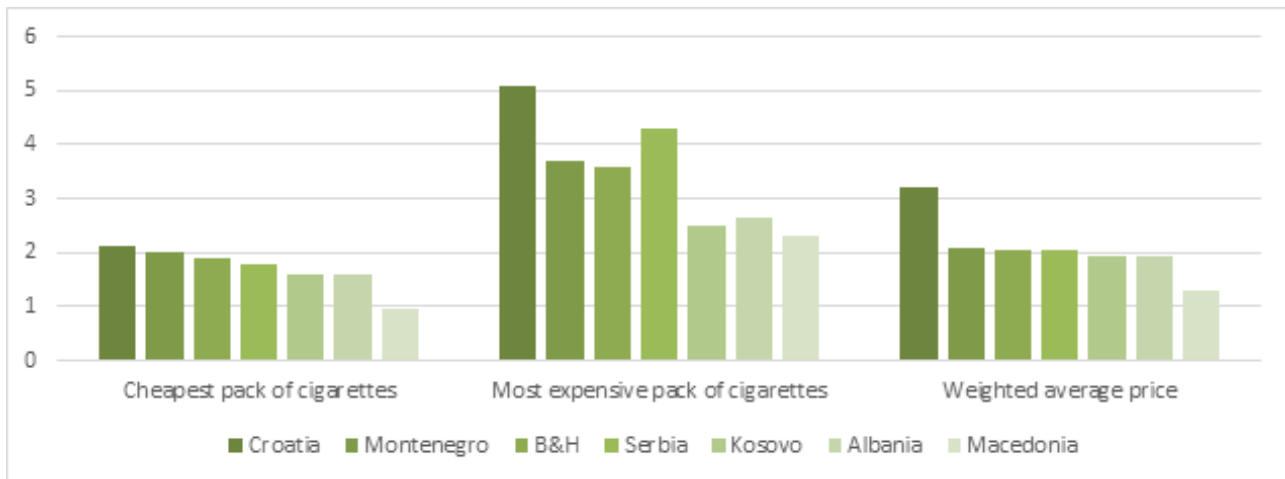
Current tobacco taxation policy is relatively predictable, characterized by a predetermined gradual increase of specific excises. Policy is mainly focused on achieving stable and predictable fiscal revenues, completely neglecting potential effects on consumption and prevalence.

Figure 2: Share of excise tax and total tax in price of cigarettes in SEE, 2018



Source: Regional study on tobacco taxation in SEE available at: <http://tobaccotaxation.org/research/>

Figure 3: Prices of tobacco products in the SEE region, 2018



Source: Regional study on tobacco taxation in SEE available at: <http://tobaccotaxation.org/research/>

Applied taxation has been reflected in significant variations of cigarette prices as shown in Figure 3. The highest price of the cheapest pack of cigarettes is in Croatia, amounting to EUR 2.14, and the lowest in Macedonia and Kosovo reflecting the lowest tax burden among the observed countries. If the weighted average

price is considered, apart from Croatia and Macedonia as outliers, prices in the region are relatively similar. Croatia leads with a price of EUR 3.21, followed by Montenegro, B&H and Serbia where the average price is around EUR 2.00.

PRICE ELASTICITY OF DEMAND FOR CIGARETTES

Research results obtained from national studies confirm price elasticity of demand to be in line with similar research conducted in other low- and middle-income countries. Depending on the applied methodology, **obtained price elasticities range from**

-0.44 in Croatia to -0.83 in B&H based on the time-series data, and from -0.45 in Serbia to -0.65 in B&H, based on household expenditure survey (HES) data.

Table 1: Estimated price elasticities based on time-series and HES data in SEE region*

Country	Price elasticity estimate – time series	Price elasticity estimate – household expenditure data
Albania	-0.78	-0.57
B&H	-0.83	-0.65
Croatia	-0.44	-1.07**
Kosovo	-0.68	-0.29
Macedonia	-0.47	n/a
Montenegro	-0.68	-0.57
Serbia	-0.76	-0.45

Source: National studies on Economics of Tobacco and Tobacco Taxation in SEE countries, available at: <http://tobaccotaxation.org/research/>

*The estimated elasticities represent % decrease in consumption, as a result of 1% increase in price

**Croatian HES analysis includes non-spenders, hence it is not fully comparable with the conditional HES estimates in the other five countries.

Results from both models suggest that **an increase in prices would result in a simultaneous rise in fiscal revenues and a**

decrease of consumption which would, apart from generating additional tax revenues, bring other benefits to the society.

CONCLUSIONS AND RECOMMENDATIONS

The results of the demand price elasticity research overwhelmingly support economic theory and are in line with global empirical evidence on the effects of tobacco taxation. In summary, **findings indicate the necessity for a change of the current policy approach in all the SEE countries**. New policies based on a dynamic increase of excises through price shocks would lead to the following outcomes:

- **Sharp decrease of tobacco consumption.** Estimated decreases of consumption, resulting from a 10% price increase, would vary from 4.4% in Croatia to 7.8% in Albania. Given the estimated price elasticity in Albania (micro model), an increase in cigarette prices of 54.7% would result in lowering demand for cigarettes by 30.6%.
- **Increase of tobacco tax revenues and opening of fiscal space for other important tobacco control measures.** As an illustration, the projected rise of fiscal revenues in Montenegro from increasing a specific excise from EUR 0.6 to EUR 1.0 (EUR 50 per 1000 cigarettes) would result in additional tax revenues of 12.35%. Similarly, increasing the retail price of the best-selling brand of cigarettes in Croatia from EUR 3.6 to EUR 5.4 would generate approximately EUR 130 million in additional tax revenues.

All the potential effects should be considered when developing specific policy solutions. A precise calculation of related systemic benefits should consider at least some of the following **policy inputs and arguments for tobacco taxation reform**, some of which stem from conducted research:

- Estimated decrease of consumption resulting from **dynamic increase of excise duties would lead to significant health care system savings** (measured in years of life and in monetary value). To illustrate, the estimated annual costs of tobacco consumption in Albania are EUR 270 million.
- **Effects of tobacco consumption have a negative impact on labor productivity, a fact largely neglected by policy-makers.** It is necessary to estimate the positive effects on productivity from lower tobacco consumption and to include them in cost-benefit analyses as a basis for taxation reform.
- **Tax increases should incorporate a projected rise of income.** Increases in income may influence affordability, undermining the effects of the tax policy reform. Taxes (and therefore prices) should be increased significantly to reduce affordability and to achieve the desired positive effects of lower consumption.

- Newly generated **fiscal revenues resulting from higher taxes would open a significant fiscal space for development spending**, such as for education, infrastructure, the overall healthcare system, and other activities aimed at achieving SDG.
- Lack of funding sources for tobacco control activities is typical for all seven SEE countries. A portion of newly generated tax revenues could be earmarked to finance tobacco control strategies and other activities whose implementation would help achieve goals set by WHO FCTC.
- There is a risk that the increase of taxes on traditional tobacco products (manufactured cigarettes in the case of SEE) could create incentives for switching to alternative (cheaper) tobacco products (e-cigarettes, roll your own, etc.). Taxation of cigarettes would therefore need to be followed by a simultaneous increase of taxes on alternative products and a simplification of the tax structure, limiting the opportunity for downward substitution.
- Policy-maker's typical fear of industry relocation to other countries needs to be countered with the **research evidence regarding development of other sectors when benefiting from lower tobacco consumption**. The development of other economic sectors should be based on the income previously spent on tobacco which would be freed and available for other spending.
- **Regional coordination of the national tax authorities and tax harmonization**, aimed at reducing the difference in prices between countries, is required to limit the space for cross-border transactions and the potential for tax evasion and avoidance.

Improved taxation systems would have to include country-specific characteristics such as price and income elasticity, current tax structure, and implementation of other tobacco control mechanisms. For that reason, taxation systems should be fostered by institutional support for strict implementation of the current legislation, a coordinated increase in taxes on alternative tobacco products, as well as regional cooperation aimed at preventing potential risks related to switching to alternative tobacco products or growth of illicit trade. In addition, governments should immediately abandon the current approach of providing direct or indirect support to the industry (i.e. subsidizing tobacco farming in Macedonia, media promotion of their investment activities, and business results in Serbia, etc.).

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1. The WHO Framework Convention on Tobacco Control (2005)
2. Data for Kosovo* has been extracted from the national office statistics and should be taken with “a grain of salt” due to different methodology
3. Eurostat. “Tobacco consumption statistics.” https://ec.europa.eu/eurostat/statistics-explained/index.php/Tobacco_consumption_statistics (accessed January 23, 2019)
4. Prevalence of smoking is the percentage of men and women ages 15 and over who currently smoke any tobacco product on a daily or non-daily basis. It excludes smokeless tobacco use. The rates derived from WHO are age-standardized.
5. The World Bank. “World Development Indicators.” <http://databank.worldbank.org/data/reports.aspx?source=2&series=SH.PRVS.MOK.FE&country=SRB#>, Updated: 11/14/2018, for Albania, B&H, Croatia, Montenegro and Serbia. For Macedonia calculations based on data from Institute for Public Health of Macedonia, WHO estimates and IMEX DATA doel Skopje estimates. For Kosovo Agency of Statistics, data derived from the Household Budget Survey.
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11. Applying only specific excises
12. The overall excise rate must be: (1) At least EUR 90 per 1000 cigarettes; (2) At least 60% of the weighted average retail selling price
13. Conducted by the Institute of Economic Sciences within the project “Accelerating Progress on Effective Tobacco Tax Policies in Low- and Middle-Income Countries”, (2018)
14. Ibid.
15. National studies conducted in seven Western Balkan countries within the project “Accelerating Progress on Effective Tobacco Tax Policies in Low and Middle-Income Countries”
16. Tobacco Atlas Fact Sheet, Albania, <https://tobaccoatlas.org/wp-content/uploads/pdf/albania-country-facts.pdf>
17. While e-cigarettes and hand-made cigarettes are present in the Western Balkans, their total consumption is still not significant and is estimated to be below 5% of the total consumption.