

Best Practices for Tobacco Tax Policies in Latin America and the Caribbean

Introduction

The most effective tobacco control tool is to significantly increase excise taxes on tobacco products. It is also a cost-effective policy. The principle is simple: A sufficiently large tax increase will raise tobacco prices, making tobacco products less affordable, thus driving down tobacco initiation, prevalence and consumption. Because tobacco demand is inelastic^{1, 2}, higher taxes generate increases in fiscal revenues. The demand for a product is inelastic when, for example, a 10% increase in price produces less than a 10% drop in consumption.

This Policy Brief addresses the challenges and opportunities for effectively implementing tobacco tax policy in Latin America with particular attention to best practices in tobacco taxation. It is based on a monograph from the U.S. National Cancer Institute and the World Health Organization.¹

Taxes on Tobacco Products in Latin America and the Caribbean

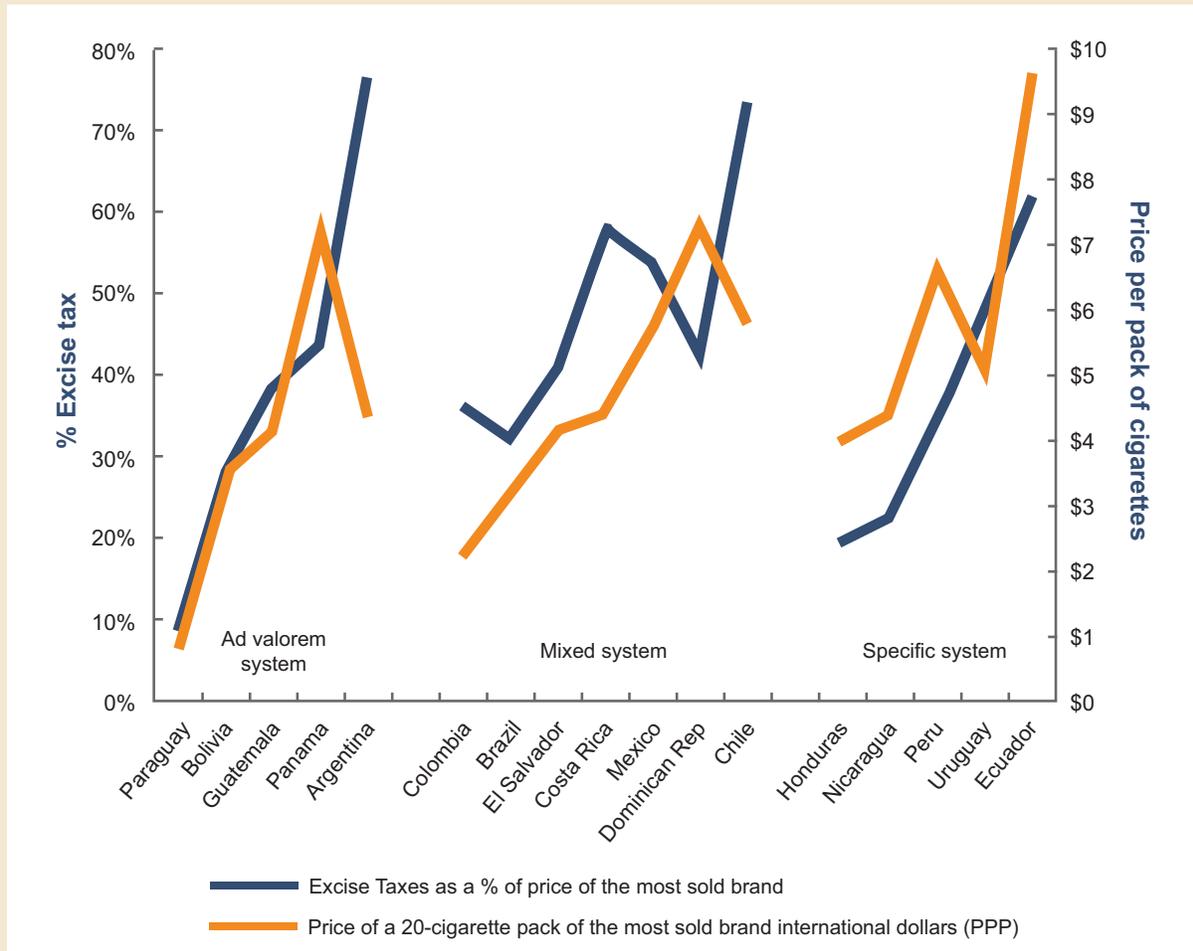
In most Latin American countries, the excise tax is the most significant of all levies on cigarettes. Excise taxes give governments the ability to influence demand by increasing prices.

Tax level and tax structure have differential effects on the retail prices of cigarettes. In Latin America, the mean excise taxes as a share of price are 39%, 48% and 37% in countries relying on ad valorem tax systems, mixed systems and specific tax structures, respectively. In the same group of countries, the average price of a pack of cigarettes is \$4.00, \$4.65 \$5.91 respectively. Countries with higher tobacco taxes have the highest prices (Figure 1), and tax structures that rely more on specific taxes (by unit, or per pack) tend to result in higher prices than structures that rely more on ad valorem taxes.

“Excise taxes give governments the ability to influence demand by increasing prices...and specific taxes tend to result in higher prices than ad valorem taxes.”

Figure 1

Price per Pack in International Dollar Purchasing Power Parity (PPP) and the Share of Excise and Total Tax in Price, by Tax Structure, 2016



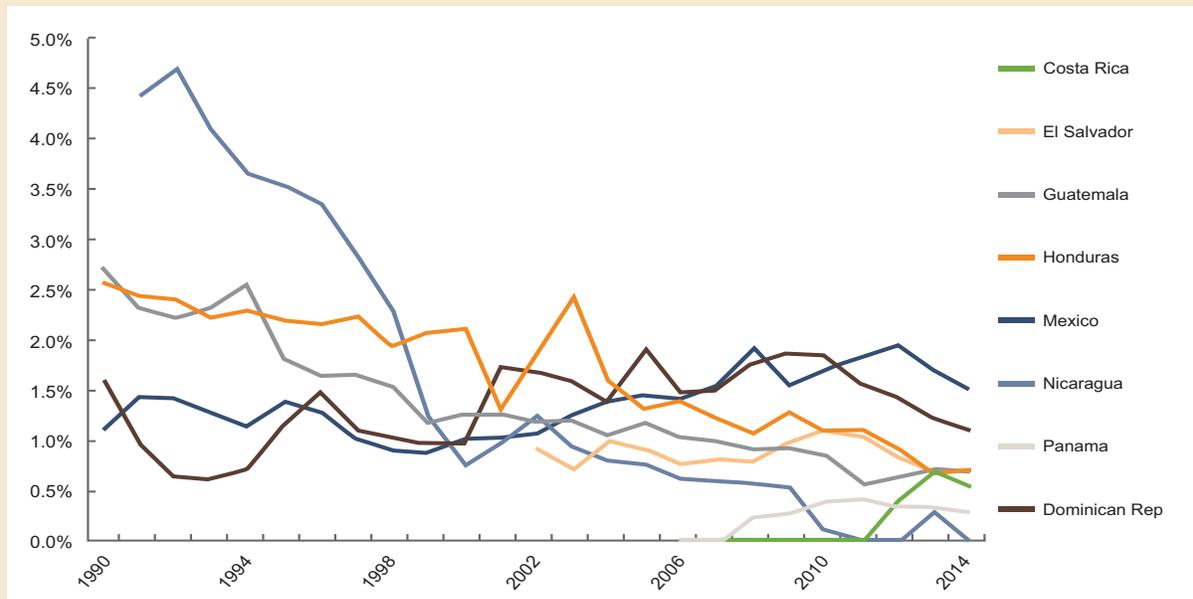
Source: Author's Calculations based on WHO Report on the Global Tobacco Epidemic 2017³

During the last two and a half decades, the relative stability of tobacco taxes and the extraordinary growth of other types of taxation resulted in a decline in the cigarette excise revenue collection as a share of total tax

revenues. Recently tobacco tax revenues represented less than 2% of national tax resources in most Latin American countries. (Figures 2 and 3)

Figure 2

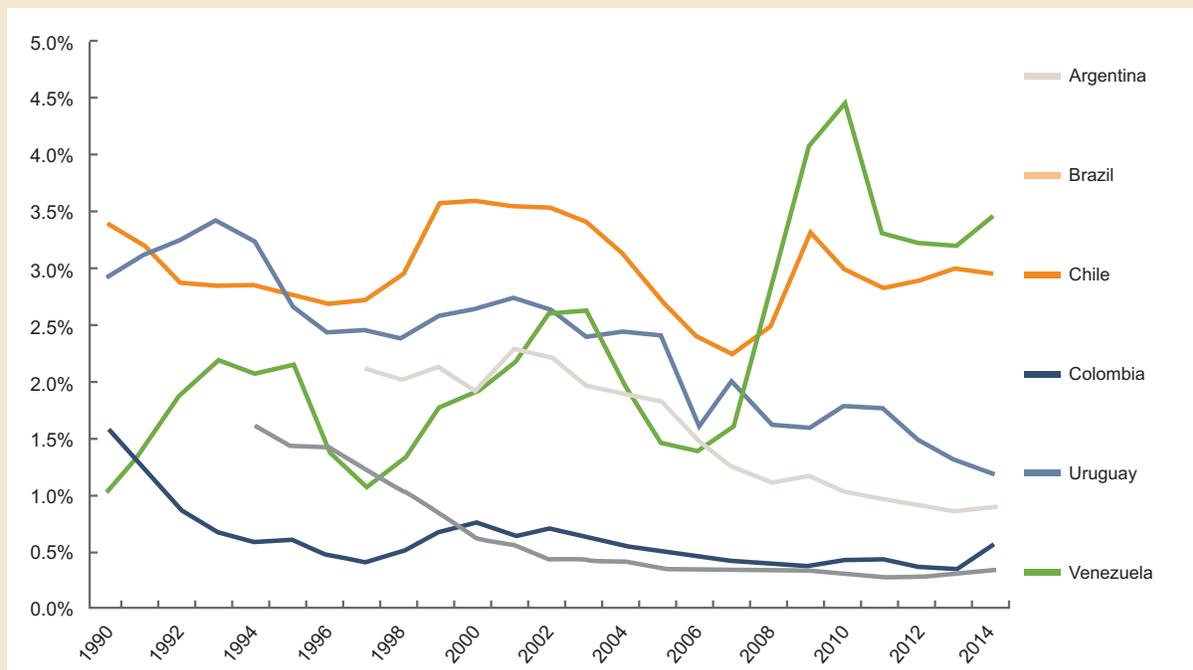
Tobacco Tax Revenue as a Percentage of Total Tax Revenues - North and Central America 1990-2014



Source: Author's calculations based on data from Economic Commission for Latin America and the Caribbean (ECLAC), and Inter-American Center of Tax Administrations (CIAT).

Figure 3

Tobacco Tax Revenue as a Percentage of Total Tax Revenues - South America 1990-2014



Source: Author's Calculations based on ECLAC – CIAT

Higher Revenues

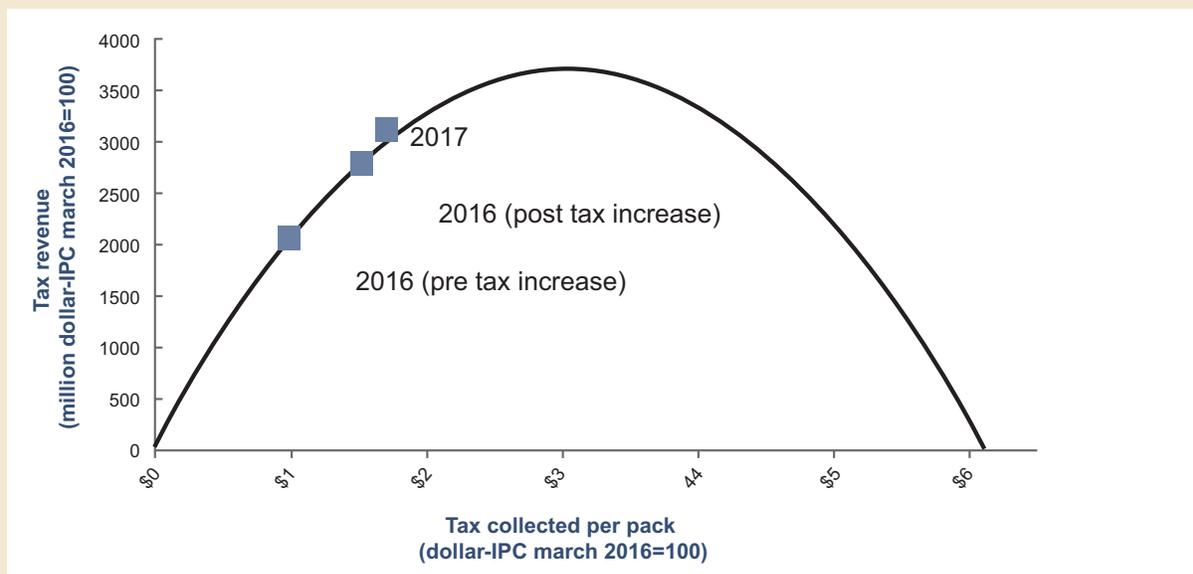
When generating higher revenue is the goal, tax policy should aim at increasing taxes on goods with the following characteristics: inelastic demand; large sales volumes from a few producers (making it easier to collect taxes); low share of tax in retail prices; clear definitions; and a lack of close substitutes. Tobacco products have most, if not all, of these characteristics, providing a relatively sustainable and profitable revenue stream.⁴

For example, in May 2016, Argentina increased the internal tax on cigarettes (the most relevant excise tax in Argentina) from 60% to 75% of the internal tax base. Before May 2016, the government collected \$1 (USD) per pack, after the tax increase the government collected \$1.54 per pack. This tax increased the weighted average price of the 20-cigarette pack by 50%. After the tax increase, excise taxes accounted for 74.98% of the retail price, and total consumption taxes accounted for 79.1% of the retail price. Expressed

in terms of March 2016 USD, the 2016 tobacco tax revenue was \$2.76 billion and 2017 tobacco tax revenue was \$3.11 billion, amounting to a \$716 million increase in revenues in 2016, and a \$1.06 billion increase in 2017.

Opponents of tax increases often claim that tax increases will lead to declines in government revenues.⁵ In the case of Argentina, however, pre-tax increase simulations showed that the government had enough room to increase taxes and reduce cigarette consumption, while still realizing higher tax revenues. Recent tax increases in Argentina did reduce consumption and raise revenues. According to the simulation, the point at which additional increases in taxes can potentially reduce revenue would be reached when taxes account for 87% of the retail price. That would still allow for cigarette tax revenues to increase by \$1.681 billion (that is, an 82.5% increase in revenues, with respect to the March 2016). (Figure 4)

Figure 4
Argentina Tobacco Tax Revenue Curve



Source: Author's Calculations based on Rodriguez Iglesias et al 2017⁶

Well-designed Tobacco Tax Policies

The various types of excise taxes each have their relative advantages and disadvantages. Specific excise taxation raises cigarette prices and reduces brands' price dispersion. This has a greater impact on public health, reducing consumption and prevalence, and is easier to administer than ad valorem excise taxes. Specific excise taxes generate more stable and predictable revenues, especially when adjusted regularly to keep pace with inflation. Governments may prefer one type of tax over the other, or prefer a combination of both, depending on political and other considerations.

Tobacco products are often subject to differential tax treatment. Typically, higher taxes are levied on cigarettes and lower taxes are levied on other tobacco products. Increasing excise taxes on cigarettes but not on other tobacco products (or increasing excises on other tobacco products at a lower rate) will result in a price gap—lowering prices for other tobacco products relative to the price for cigarettes. In 2007, for example, Uruguay increased the cigarette excise tax, but

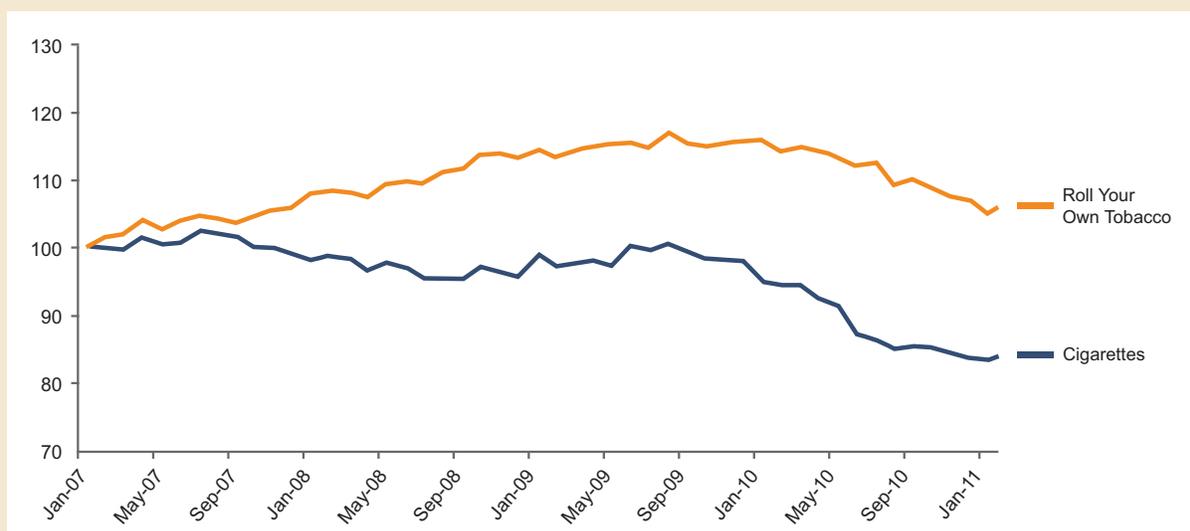
not taxes on other tobacco products, mainly roll-your-own (RYO) tobacco. As a result, sales of RYO products increased, reducing the effectiveness of the tobacco tax increase. (Figure 5)

If non-cigarette taxes are not changed (or changed less than cigarettes), there will be a larger reduction in cigarette consumption due to some substitution to other products. Consequently, the overall reduction in tobacco use will be smaller than if taxes on cigarettes and other tobacco products are increased by similar amounts. Reducing this price gap will lessen the likelihood that consumers will switch to or substitute less expensive tobacco products. As a result, in order to maximize the public health impact, tax increases may need to be greater for other tobacco products than for cigarettes.

A simple and unified excise tax system with comparable tobacco products taxed at the same level is considered a well-designed tax policy in terms of ensuring transparency, simplicity, and ease of tax administration. Moreover, a strong case can be made for specific excise taxes,

Figure 5

Index of sales Tobacco Products Uruguay (Jan 2007= 100)



Source: *Direccion General Impositiva - Uruguay*

because they generate more predictable revenues and are more effective at reducing cigarette consumption by increasing average cigarette prices than *ad valorem* taxes. Tobacco industry can manipulate the base on which *ad valorem* taxes are calculated in a way that tax increases are not reflected in price increases. Furthermore, a uniform specific excise reduces price gaps between brands and tobacco products, minimizing substitution behavior of consumers among brands and products.⁴

Strong Tax Administration

Even well-designed tobacco excise taxes cannot be successful in achieving health and revenue objectives without strong tax administration. Effective measures exist for mitigating the impact of inflation and for curbing illicit tobacco trade, but implementing them requires political will.

The real value of specific tobacco taxes will fall over time as general price levels increase, decreasing real value tax revenues and reducing the effectiveness of the tobacco tax policy. Policymakers must ensure that there are mechanisms for automatically adjusting specific taxes to keep pace with inflation. In countries with high inflation and large increase in incomes, more frequent adjustments are needed.

In order to maximize the public health impact of higher tobacco taxes and generate higher revenues, effective tax administration would raise taxes so as to increase real prices and reduce the affordability of tobacco products. Good tax administration requires strong technical capacity by the administrative agency. Compliance can be strengthened by adopting independent industry monitoring and tracking and tracing systems

combined with enforcement. Existing evidence suggests that old tax stamps are less effective in deterring illicit or counterfeit cigarette production and trade, but are better than having no tax stamps at all. New technologies provide better enforcement tools for governments. In addition, the costs of adopting and implementing a new technology can generate more than enough revenues to pay for itself by collecting taxes that would otherwise not be paid.^{4,4}

The experience of Panama demonstrates that increased enforcement capacity can be funded by the increases in tobacco taxes. Law 69/09 increased the Selective Excise Tax on Cigarettes and other tobacco products by 100%. One-half of the total Selective Excise Tax on Cigarettes revenue was earmarked, allocating 40% to the Ministry of Health; 40% to the National Cancer Institute; and 20% to the National Customs Authority.⁷

Conclusion

The evidence from Latin America and the Caribbean demonstrates that higher tobacco taxes will generate higher tax revenues, while at the same time improving public health by reducing tobacco use. The new revenues can be used to support other tobacco control and health promotion measures as well as enforcement mechanisms to successfully reduce illicit trade. The strength of administration comes from the ability to monitor and enhance tax compliance by reducing opportunities for tax evasion and tax avoidance. In addition, well-designed tax policies are necessary to achieve both revenue and public health goals.

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Tobacconomics is a collaboration of leading researchers who have been studying the economics of tobacco control policy for nearly 30 years. The team is dedicated to helping researchers, advocates and policymakers access the latest and best research about what's working—or not working—to curb tobacco consumption and the impact it has on our economy. As a program of the University of Illinois at Chicago, Tobacconomics is not affiliated with any tobacco manufacturer. Visit www.tobacconomics.org or follow us on Twitter www.twitter.com/tobacconomics.