Smoking, Health & Public Finances: Opinion piece in Gulf Business, Aug 2015

This article appeared in the print edition of Gulf Business, August 2015. Click here to download the print version.

Last month, the GCC countries endorsed a call by the World Health Organisation (WHO) to raise taxes by 100% on tobacco. The avowed aim is to reduce tobacco consumption and, as well, raise government revenue. According to the WHO and the Tobacco Free Initiative (TFI), a 10% price increase on a pack of cigarettes would be expected to reduce demand for cigarettes by about 4% in high-income countries and by about 5% in low- and middle-income countries, where lower incomes tend to make people more sensitive to price changes. The "WHO Report on the Global Tobacco Epidemic 2015″, estimates that about 6 million people a year die from tobacco-related diseases, with that number forecast to increase to 8 million people by 2030. So reducing consumption by raising cigarette prices could have important health benefits. For an economist the issue is what is the best policy measure(s) to achieve the desired objectives of improving health outcomes while preserving and/or increasing government revenues from taxing tobacco? The issue typically pits Finance Ministers who find taxing tobacco, alcohol, gambling and other "pleasures" human animals indulge in, is a highly lucrative contributor to public revenues, against Health Ministers and others who want to severely shrink such consumption. What should be done?

MENA is a Fast-Growing Consumer Market for Tobacco

The Middle East and North Africa (MENA) region is one of the fastest growing consumers of tobacco products, especially cigarettes. With a young, fast-growing population, where smoking is culturally acceptable and with a low awareness of health implications, tobacco consumption is high. In 2010, the region accounted for a 7.1% market share of global cigarettes volume, the fourth largest globally. Significantly, the smoking of pipe tobacco in the region, popular due to the consumption of shisha, represents roughly 45.5% of global demand. By country, Saudi Arabia has the highest per capita consumption of shisha pipe tobacco in the world while Egypt, which is MENA's largest cigarettes market due to its large, 80+ million population, consumes most in volume terms. Saudi Arabia, with the largest GCC population, is the largest market for the cigarette industry, closely followed by the UAE. Saudi Arabia ranks fourth in the world in terms of tobacco imports and consumption. Saudis smoke more than 15 billion cigarettes a year according to figures from the GCC Council of Health Ministers.

International & Bilateral Agreements Constrain GCC Tobacco Tax Policy

Typically, governments increase tobacco prices by raising the price paid by consumers through higher import duties, General Sales Taxes (GST) or Value Added Tax (VAT), selective sales taxes (excise taxes in technical jargon) or a combination. As an indicator, on average for the OECD countries excise taxes represent some 60% of cigarette prices, while VAT represents some 15%. There is clear evidence that moderate increases in taxes is an effective public policy measure for reducing tobacco consumption, while also raising government revenues. The reason is that demand for cigarettes is inelastic: if higher taxes increase prices by 10%, consumption falls less than 10%; this means that quantity consumed declines but total spending increases, along with government revenue.

However, the GCC countries do not possess the above policy options. They do not have modern tax systems and have signed international & bilateral trade agreements that prevent them from raising custom duties (the GCC Common External Tariff) on cigarettes and other tobacco products.

The GCC nations are members of the WTO and have to comply with their treaty commitments and with a maximum import duty ("bound rate"). The current 100% import duty across the GCC is set at the bound rate for both Bahrain and Kuwait. Furthermore, free trade agreements signed by Bahrain and Oman with the US dictate that the countries remove tariffs on cigarettes (among other products) by 2016 and 2019 respectively. Last, but not least, the GCC Customs Union agreement includes a Common External Customs Tariff (CET) for goods imported from outside the GCC, as well as common customs regulations and procedures, which further constrains tobacco tax policy options. Given these constraints, raising customs duties is not an available option. What is the alternative?

Taxation of Tobacco Products: VAT + Excise Tax

The GCC currently rely entirely on import duties for revenue from tobacco products but these trade tax revenues are being gradually eroded as a result of free trade commitments. The GCC countries are also highly reliant on oil export revenues which represent some 85% of government revenues and have been severely hit by the fall in oil prices. To build fiscal sustainability and protect their expenditure plans the GCC need to diversify their sources of revenue. GCC tax policy reform and innovation is required. The most efficient reform would be to introduce both broad-based sources of consumption taxation (a GST or a VAT) along with indirect taxes (domestic excise taxes) on specific goods and products like gasoline, diesel, alcohol and tobacco.

Why Excise Taxes?

Empirical evidence shows that indirect taxes levied on tobacco products have the most significant policy impact on the price of tobacco products and consumption. Within indirect taxes, excise taxes are the most important because they are applied directly to tobacco, and contribute the most to substantially increasing the price of tobacco products and lowering demand.

Excise taxes can be either specific taxes (based on quantity) or *ad valorem* (based on value). Economic theory and evidence indicates that the choice of a tobacco excise tax structure will have a significant impact on a government's ability to achieve its objectives. Uniform specific excise taxes on cigarettes (e.g. $2 per pack of 20 cigarettes) are relatively easy to administer. Given that tax administration in most GCC countries is underdeveloped, specific excise taxes are easier to administer and collect. By contrast, price-based taxes and ad valorem taxes are more difficult and costly to administer, as they require determination of value (which can be subject to manipulation) and therefore require an experienced tax administration in order to deter tax avoidance. The revenues generated by ad valorem taxes are also more sensitive to pricing decisions than revenues generated by specific taxes. On the other hand, the real value of specific taxes will erode over time unless tax rates are regularly adjusted for inflation in contrast to ad valorem taxes which will rise with prices.

Domestic Excise Taxes are the Way Forward to Address Health & Revenue Objectives[1]

The GCC countries should agree and introduce specific excise taxes on tobacco consumption as a new policy tool to increase tobacco prices for health reasons as well as to raise revenue. The recommendation is for a specific nominal excise duty to be introduced in each GCC member state consisting of a fixed amount $xx per 1,000 cigarettes or equivalent units of other tobacco products such as shisha tobacco. Such a policy reform would simultaneously reduce consumption *(in accord with the directives of Health Ministries)*, gradually raise prices towards relevant international benchmarks and raise substantial revenues *(satisfying the objectives of Finance Ministries)* for governments. Ministries of Finance could introduce the new excise duty, enabled by the necessary legal & regulatory reforms, and would set up the required revenue administration.

It is also preferable that the GCC countries cooperate and harmonise tax policy. The introduction of tobacco excise taxes should be applied uniformly (including on domestic production, such as in Free Zones), equally and in synchronized manner in all countries in order to prevent arbitrage opportunities and illicit trade or smuggling. The process of implementation of the new tax structure should also be gradual to avoid encouraging smuggling & illicit trade, and while building tax capacity in the form of tax revenue authorities to implement the excises, monitor and collect revenue. The introduction of excise taxes and set-up of an excise revenue administration also has the added advantage of facilitating the introduction of other excises, notably on gasoline, diesel, alcohol and other products – gradually leading to revenue diversification and eventually fiscal sustainability.

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[1] For additional analysis see the White Paper on "GCC Fiscal Reform: Oil, Government Revenue, Excise Taxes & The Tobacco Market" http://nassersaidi.com/2014/12/04/white-paper-on-gcc-fiscal-reform-oil-government-revenue-excise-taxes-the-tobacco-market/