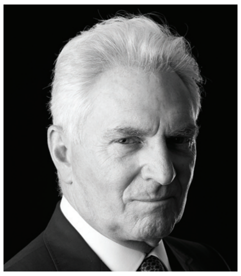

Smoking, health and public finances

A tobacco tax could help GCC countries meet both health and fiscal objectives, writes Dr Nasser Saidi

Last month, the Gulf Cooperation Council countries endorsed a call by the World Health Organisation to raise taxes by 100 per cent on tobacco. The avowed aim is to reduce tobacco consumption and raise government revenue. According to the WHO and the Tobacco Free Initiative, a 10 per cent price increase on a pack of cigarettes could reduce demand for cigarettes by about 4 per cent in high-income countries. This increases to about 5 per cent 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 six million people a year die from tobacco-related diseases. This is forecast to increase to eight 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 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' a highly lucrative contributor to public revenues against health ministers and others who want to severely shrink consumption. What should be done?

Illustration by Gausa Victor Danusovich

MENA is a fast-growing consumer market for tobacco

The Middle East and North Africa region is one of the fastest growing consumers of tobacco products, especially cigarettes. The combination of a young, fast-growing population where smoking is culturally acceptable with a low awareness of health implications means tobacco consumption is high. In 2010, the region accounted for a 7.1 per cent share of global cigarettes by 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 per cent of global demand. By country, Saudi Arabia has the highest per capita consumption of shisha pipe tobacco in the world. Meanwhile, Egypt is MENA's largest cigarettes market due to its large (more than 80 million) population. It also consumes most in volume terms. Saudi Arabia, with the largest GCC population, is the biggest market for the cigarette industry, closely followed by the United Arab Emirates. The kingdom 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 agreements constrain GCC tobacco tax policy

Typically governments increase tobacco prices through higher import duties, general sales, value added or selective sales tax or a combination. On average, Organisation for Economic Co-operation and Development countries' excise taxes represent some 60 per cent of cigarette prices. And VAT represents some 15 per cent. There is clear evidence that moderate increases in taxes are an effective public policy measure for reducing tobacco consumption, while also raising government revenues. Demand for cigarettes is inelastic. If higher taxes increase prices by 10 per cent, consumption falls less than 10 per cent. This means that consumption 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 and bilateral trade agreements that prevent them from raising custom duties. The GCC Common External Tariff on cigarettes and other tobacco products is one such example.

The GCC nations are members of the WTO and have to comply with their treaty commitments and with a maximum import duty. The current 100 per cent import duty across the GCC is set at the bound rate for both Bahrain and Kuwait. In addition, free trade agreements signed by Bahrain and Oman with the United States 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 for goods imported from outside the GCC as well as common customs regulations and procedures. This 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 and excise tax

The GCC currently relies 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 (representing some 85 per cent of government revenues), which have been severely hit by the fall in oil prices. To build fiscal sustainability and protect their expenditure plans GCC countries needs 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 along with indirect taxes on specific goods. These could include 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. They are applied directly to tobacco and help substantially increase the price of tobacco products while lowering demand.

Excise taxes can be either based on quantity or value (ad valorem). Economic theory and evidence indicates that the choice of a

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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 and collect. This would suit the relatively underdeveloped tax administration in most GCC countries. By contrast, price-based taxes and ad valorem taxes are more difficult and costly to administer. 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. On the other hand, the real value of specific taxes will erode over time unless tax rates are regularly adjusted for inflation. In contrast, ad valorem taxes will rise with prices.

Domestic excise taxes to address health and revenue objectives

The GCC countries should agree and introduce specific excise taxes on tobacco consumption – both as a policy tool to increase prices for health reasons and to raise revenue. My recommendation is for a specific nominal excise duty to be introduced in each GCC member state. This would consist of a fixed dollar amount per 1,000 cigarettes or equivalent units of other tobacco products such as shisha. Such a policy reform would suit both finance and health ministries. It would simultaneously reduce consumption, gradually raise prices towards relevant international benchmarks and substantially boost revenues for governments. Ministries of finance could introduce the new excise duty, enabled by the necessary legal and regulatory reforms and 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 domestic production, such as in free zones. It should also be applied equally and in a synchronised manner in all countries in order to prevent arbitrage opportunities and illicit trade or smuggling. With this in mind the process should be gradual. This would discourage smugglers while allowing time for the set-up of tax revenue authorities to implement the excises, monitor and collect revenue.

These authorities could then facilitate the introduction of other excises – notably on gasoline, diesel, alcohol and other products – gradually leading to revenue diversification and eventually fiscal sustainability.