

- The excise tax structure is as important, if not more important than the level of the excise tax
- In a country with low excise taxes and poor excise tax structure, it is best if countries first clean up the structure, then raise the excise tax
- The tobacco industry typically likes complicated (tiered) tax structures because they provide scope for the industry to reduce their tax liability by manipulating their products to fit the lower taxed category
- If the tobacco industry strongly opposes a tax structure or increase, it is usually a sign that it works

Types of excise taxes



- Excise taxes are levied on specific products, usually to discourage the use thereof. There are two types of excise taxes: specific and *ad valorem*.
- A specific excise tax is charged per quantity, such as per cigarette, pack, or kilogram (e.g., \$1.50 per pack of 20 regardless of price).
- An *ad valorem* tax is charged as a percentage of the value of the product. The value of the product is measured by the manufacturer's price (e.g. 80% of the manufacturer's price) or by the price paid by consumers (e.g. 70% of pre-tax retail price).
- It is also possible to combine an *ad valorem* with a specific tax. There are five possible excise tax structures that can be applied to tobacco products:

excise applies on the value of the products however, if the *ad valorem* excise falls below a minimum floor, a specific tax applies.

5. A combination of a mixed duty for medium priced and/or premium brands and a specific duty for cheaper brands. A mixed excise applies; however if the mixed excise falls below a minimum floor, a specific tax applies.

Types of excise tax structures



1. Purely specific: the a tax base per unit e.g. per 1000 cigarettes or per 1 kg tobacco.
2. Purely *ad valorem*: the tax base is the value of the products (e.g. ex-factory price/retail price).
3. Mixed: a combination of both *ad valorem* and specific duty.
4. A combination of an *ad valorem* duty for medium-priced and/or premium brands and a specific duty for cheaper brands. The *ad valorem*

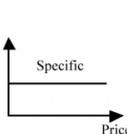
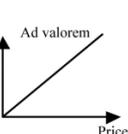
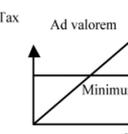
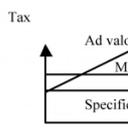
Which tax structure is the best?



- Specific taxes are more favourable than *ad valorem* taxes because they lead to higher retail prices and are easier to administer than *ad valorem* taxes.
- The WHO FCTC Article 6 guidelines recommend that Parties implement “specific OR mixed excise systems with a minimum specific tax floor, as these systems have considerable advantages over purely *ad valorem* systems...”.
- In practical terms this means that if has a purely *ad valorem* system, they should at the very least, add a specific element to it.
- The WHO also advises Parties that “all tobacco products should be taxed in a comparable way so as to minimize the incentive for users to shift to cheaper products or product categories...”.

Tobacco Taxation Systems: Ideal Tax Structure

Comparison of structures for excise duties on prices and government revenue

| | Specific excise | <i>Ad valorem</i> | Mixed | <i>Ad valorem</i> with a specific minimum floor | Mixed with a specific minimum floor |
|---|---|--|--|--|--|
| Effect on prices | | | | | |
| Tax/price structure |  |  |  |  |  |
| Impact on prices | Tends to entail relatively higher prices Tax increases may lead to "over shifting" or upwards product substitutability | Relatively lower prices compared to specific Tax increases may entail down trading or price reductions ("under shifting") | The effect will depend on which element (<i>ad valorem</i> or specific) prevails | The minimum tax functions as a specific duty and ensures a relatively higher price level for low (and medium) priced products | |
| Inflation | Real value will be eroded by inflation, unless adjusted in line with inflation | The real value will be preserved as prices increase to the extent that tobacco prices follow inflation | Real value of the specific element will be eroded by inflation | Real value of the minimum floor will be eroded by inflation The minimum floor may be (partly) adjusted for inflation if it is a percentage of the excise due on WAP* or of a premium price category subject to <i>ad valorem</i> taxation | Real value of the specific tax and the minimum floor will be eroded by inflation The minimum floor may be (partly) adjusted for inflation if it is a percentage of the excise due on WAP or of a premium price category subject to <i>ad valorem</i> taxation |
| Impact on government revenue | | | | | |
| Budgetary stability/ability to forecast | More stable as compared to <i>ad valorem</i> Easy to forecast | Vulnerable to changes in consumers' and producers' behaviour Difficult to forecast | More specific or a minimum tax floor will entail more budgetary stability | | |
| The real value of taxes and prices | The excise needs to be periodically adjusted for inflation | The excise may have to be periodically adjusted for down trading or price reductions | The excise may have to be periodically adjusted for inflation, down trading or price reductions | | |
| Reduction of tax induced cross-border operations (private imports and illicit trade) | For specific and <i>ad valorem</i> , with the same tax level at WAP, a situation of purely specific taxation in one country/jurisdiction and purely <i>ad valorem</i> taxation in a neighbouring country could result in cross-border flow for premium brands from one country to a second country, with cheap brands flowing in the opposite direction | | The more the structure relies on specific or minimum duties the less vulnerable it becomes for down trading or price reductions but the more the tax can be eroded by inflation Mixed tax structures and tax structures including a minimum floor are less vulnerable to cross border flow induced by the tax structure | | |
| Administrative requirements | No price monitoring required for tax purposes only the volume or weight has to be ascertained | | Requires price monitoring | | |
| Source: IARC. 2011. Effectiveness of Tax and Price Policies for Tobacco Control. IARC Handbooks of Cancer Prevention Volume 14. pp 27-28. * WAP = Weighted Average Price | | | | | |