

## CHAPTER 2

### THE TAXATION OF TOBACCO

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#### Introduction

The effects of tobacco and the various measures used by government, including taxation, have been very much in the news in recent times. The Food and Drug Administration in the United States introduced a set of new regulations in 1997 intended to reduce smoking among young people. More damaging from the tobacco industry's point of view is a series of lawsuits that are coming to trial in the United States, some for medical expenses incurred by states, others for the suffering of individuals and groups of people. In some of these cases, deals have already been struck whereby some tobacco companies are prepared to admit liability and make large payments in exchange for immunity from further lawsuits, thereby requiring some tobacco companies to admit, for the first time in 40 years, that tobacco causes cancer and that it is an addictive substance (*Economist*, 1997).

In Europe, similar moves are afoot intended to reduce smoking, but especially amongst young people (Commission of the European Communities, 1996). Noteworthy, though, is the lack of progress in relation to the harmonisation of structures, let alone rates, for the taxation of cigarettes and other forms of manufactured tobacco products. One of the major reasons perhaps for the lack of progress is that decisions on such matters are initiated under Article 99 of the Treaty, which requires unanimity, as opposed to a qualified majority, for them to be carried.

A new study for the European Parliament in Strasbourg, in 1997, meantime has given an urgency to the tobacco tax issue not only in Europe, but across the world. It confirmed what many people have known for some time, namely that the very high levels of taxation on the consumption of tobacco products have created a huge illegal trade in cigarettes, with major criminal players involved.

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This is the background to the present chapter. A number of questions will be looked at. First, in Section 2 the rationale for government intervention in the tobacco trade, especially through the imposition of special taxes, will be examined in some detail. There has always been a rationale in relation to the provision of adequate information, but more recently the objective for some organisations has been explicitly to reduce tobacco consumption significantly. Even if such an objective is accepted, the issue then arises as to the role of taxation in achieving this objective and the consequential costs associated with the tax measure. This will be discussed in Section 3. There are the costs in terms of the effects on income distribution, and the large illicit trade in cigarettes that is resulting from the high levels of taxation on tobacco products. Section 4 will look at the issue of the structure of tobacco taxation, especially as it applies in the European Union (EU), and Section 5 will conclude the chapter.

#### Taxation and the Unaccounted for Costs of Smoking

##### The Idea of Social Cost

In attempting to answer the question why governments place special taxes on the consumption of tobacco, economists usually examine actual situations by relating them to an 'ideal type' – which essentially consists of a set of perfectly functioning markets, operated by rational individual actors. Government intervention is justified where some activity has a social cost: only then can the government intervene (assume for the moment there is no information problem), e.g. by imposing a tax.

The social cost argument runs as follows: before anybody does anything in the market, they weigh up the costs and benefits of any action they are considering. Because it is assumed that each individual is rational and self-interested, for a cost and/or benefit to be included in the calculation, it must satisfy two conditions: (i) it must be foreseen by him/her, and (ii) it must be an 'own cost' or 'own benefit' in that it will be borne by him/her. This individual weighs up all foreseen own costs and all foreseen benefits, and if the latter exceeds the former the action is carried out, but if the former exceeds the latter it is not. To use the example of smoking, the benefits would be, for example, the personal satisfaction from smoking and the social ease it permits in some situations, and the cost – assuming for the moment that there is only one relevant cost – the purchase price. Costs not borne by the potential smoker will not be

included – and at first sight, the costs of 'passive smoking', or the public health costs, seem like classic examples of such an external or social cost. It is quite possible that the smoker will foresee such costs to others, but will not include them in the calculations because they are not relevant. Thus the argument goes, the government must intervene by imposing a tax to the amount of the above costs to others of each cigarette, or more specifically the marginal external cost per cigarette. The cost to others enters as an own cost or private cost through the cost of the cigarette itself and if the new augmented cost still does not exceed the benefits of smoking, the person continues to smoke.

The translation of this principle in its pure form into reality is, however, almost impossible. The marginal external cost associated with the consumption of each cigarette depends on who smokes it, under what circumstances it is smoked, and where it is smoked. Apart from the fact that information on the marginal external cost for each circumstance simply does not exist, there would be the rather ludicrous administrative problem of applying these different rates. The best practical equivalent of this approach is the 'insurance' approach to taxing external costs of tobacco consumption – smokers as a group should meet all of the costs to the exchequer of smoking through a uniform general tax on the consumption of all tobacco. In this sense, tobacco tax can be regarded as a premium, similar to motor insurance, in that it is related to the overall costs imposed, as measured by the numbers of cigarettes consumed.

##### Passive Smoking

The insurance approach to tobacco taxation, though, does not deal with the passive smoking issue. The external or social cost of passive smoking is not borne by the individual or the exchequer, but involuntarily by a third party. This cost of smoking has been given enormous publicity in the last two decades or so and one consequence is that, in many public places, smokers tend to be segregated from non-smokers, or else smoke alone. Indeed, the World Health Organisation (WHO) has the aim of reducing smoking to the status of a private activity of a minority of adults who are unable to give up the habit (Chollat-Traquet, 1996).

The difficulty with this cost is that it cannot really be dealt with through taxation. Apart altogether from the link between passive smoking and the incidence of cancer (which, while queried strongly in the past, is rarely challenged today), the existence of other people's smoke can cause irritation and watery eyes, and in general pollutes the environment for

others present through the existence of unpleasant smoke and odours in the air.<sup>1</sup> The fact that smokers may be paying high levels of taxation to the exchequer to compensate for these and other costs of their smoking is no consolation to those present, as these particular costs are very specific to the individual and affect no other taxpayer. They could leave the area where the smoking is taking place, but why should they if the area is a public area, or if there is no part of the public area where they can go to undertake their work or pursue their leisure interests?

Regulation and legal instruments, not taxation, are the main ways to deal with such issues. In the European Union (EU) a Resolution of 1989 has led to major changes, particularly in relation to the banning of smoking in enclosed premises open to the public and in all forms of public transport (Commission of the European Communities, 1996). It is noteworthy that in this Resolution it was agreed that clearly defined areas should be reserved for smokers, including in public transport on long journeys. This allayed the fears of some that smoking might be banned in all areas of a public building or a public transport carrier, even though over 40 per cent of the adult population of the EU still smoke. In areas other than those reserved for smokers, though, the right to health of non-smokers was to prevail over the right of smokers to smoke. Such measures have gone a lot further in the United States (Fritschler and Hoeller, 1996). For example, no smoking rules for certain areas were introduced there as far back as 1972, and Congress, in 1989, banned smoking on all commercial domestic airline flights, regardless of duration. In 1994, McDonalds decided to ban smoking in all of its 9,000 chain-owned restaurants, with other similar organisations following suit.

An outright ban on smoking in public places is the polar opposite position to allowing smoking at will in all public areas. Neither policy is optimal, as in many public areas the costs imposed on non-smokers is as much to do with the quality of the air-conditioning as on the fact that someone is smoking. It is also possible that the loss of welfare to smokers through the imposition of the ban may not be compensated by the gain in welfare to non-smokers. It may be that people have a right to clean air in public places, but why then is this not applied with the same vigour to air near public thoroughfares or to noise created by third parties in both private and public areas? 'Smoking today, what we wear tomorrow' may

<sup>1</sup>It is interesting to note that, in Elizabethan times, the smoke from tobacco was considered desirable as it smothered odours resulting from the then reluctance to take baths!

be oversteering the situation, but it is this type of fear that has bred pro-smoking lobbies in countries such as the United Kingdom in recent years (Nicholson, 1994). Despite this, it is now generally accepted that people have the right to clean air, both in their work environment and in their leisure activities especially where they take place in confined spaces.

#### Public Health and Other Exchequer Costs

An external or social cost that is susceptible to correction through tax policy is the public health and other costs of treating the victims of smoking. Smokers tend to use public health facilities more often than non-smokers and thus, in the absence of special taxes, are in effect being subsidised by non-smokers to smoke. However, this is only true in a system where medical care is provided by the state completely free of charge. Thus the problem may not be due to the fact that people smoke, but rather the institutional health arrangements of that particular state. In fact, however, a system of completely free medical care rarely exists and for many people there is usually at least a partial private insurance element in health care costs. Thus, to this extent, smokers do not burden non-smokers with the additional health care costs resulting from the fact that they smoke. In large part though it is the case that the health care costs of smokers, in the absence of special taxes, would be subsidised by non-smokers.

If the principle were introduced that smokers should pay for their treatment, either through special taxes or by being rejected for treatment in public hospitals, because their illness is willingly self-inflicted, then there seems to be no reason why it should not be extended to any victim of a risky undertaking, e.g. to someone who eats a lot of butter or someone who is injured when playing rugby football or skiing. Another issue is that if smoking does affect health in the manner alleged, then smokers should die younger and thus cease to draw on state pensions, geriatric care, etc. It is quite possible that the costs of treating age-related diseases is greater than that of treating smoking-related diseases, or at least that they balance out. In short, if one looks at life-cycle health costs, then the argument that smokers impose a burden on non-smokers may have little foundation. Atkinson and Townsend (1977) found that the actual cost savings to the exchequer from a hypothetical 40 per cent reduction in cigarette smoking were relatively small. Indeed, as new non-smokers aged they would consult general practitioners more, resulting in a net increase in consultation costs within 25 years. In fact, the major savings would not be

in health costs at all, but in the non-payment of sickness benefit and widow's benefit.

Lost output due to the effects of smoking on a worker is often quoted as a social cost of smoking – but if workers are being paid on an output or time basis, then any lost output will be reflected in a lower wage packet, i.e. it is a cost that will be foreseen by them and be borne by them, and is thus not a social cost. For many workers this is not the case though, and there is in fact a cost to the state arising from their inability to work, through the payment of sickness benefit etc.

Increasingly in the United States and Europe, the financial costs imposed by smokers on non-smokers are being internalised (Chollet-Traquet, 1996). Differential mortality rates for smokers and non-smokers have led to actuarial studies demonstrating a fiscal basis for different risk ratings for life insurance. All life assurance companies in the United States offer discounts to non-smokers and thus the differential cost of life assurance is now borne by smokers themselves. In addition, some countries offer non-smokers discounts for health insurance and property insurance, not just to individuals but to companies. This and other considerations could mean that all things being equal, employers will favour hiring non-smokers. The outcome of all of these developments is that the costs of smoking that were once borne by third parties are now borne by smokers themselves.

These though are costs borne by others through the existence of non-differential premiums for private insurance. The insurance principle to taxation is still broadly applicable where costs are imposed by smokers on the exchequer. However, apart from the broad issue discussed above, there is the issue of measuring precisely what these net costs are and thereby setting the 'correct' level of special tax that will recoup them for the state. It is possible that the existing tax rates in some EU countries in particular are at levels way above those required to recoup such costs. Whatever the true situation, it is difficult indeed to explain the variation in the rates of special taxes on tobacco in different countries (see later) in terms of varying exchequer costs.

#### Lack of Information

As mentioned, for a cost to be included in the cost-benefit calculation of a smoker, the cost must be foreseen and be borne by the smoker. So far costs that will quite possibly be foreseen but will not be borne by the smoker have been discussed. There remains the possibility of a cost

which although it will be borne by the smoker eventually, does not enter the cost-benefit decision at the purchase stage. An illustration would be if a smoker bought a packet of cigarettes unaware of the health risks of such cigarettes and was later afflicted with cancer. At the time of purchase, known costs and benefits are not accurately reflecting true costs and benefits and a 'wrong' decision is being made. Thus, in principle, a significant cost is being overlooked, if (i) there was a causal link between smoking and ill health, and (ii) smokers did not know about such a relationship. This, of course, is the basis of many of the lawsuits in the United States.

Nowadays, information about the ill health resulting from smoking is almost impossible to avoid and tobacco products in many countries are now forced to carry health warnings, and extensive anti-smoking advertising and educational campaigns are commonplace. The emphasis recently has been on providing information and protection for young people, especially as around 1 per cent of those aged 11 years in the EU are already smoking, a figure rising to as high as 30 per cent for those aged 15 years. The early age of starting smoking, combined with the addictive nature of smoking, suggests that particularly active measures must be taken to 'protect' younger age groups from persuasive advertising and promotion of a product the costs of consumption of which they are too young to assess and comprehend until it is too late. Particularly strong measures have been adopted in 1997 in the United States. For example, cigarette vending machines are to be restricted to places where those under 18 never go, cigarette billboards are to be banned from within 300 metres of schools and cigarette advertisements are to have no colour (leaving them only the aptly named 'tombstone' format of black words on white paper), except in magazines which have few young readers or in places where youngsters never go (*Economist*, 1997).

Few economists would question this public information function of the state, especially in relation to a product which is addictive and whose adverse effects are so long-term in nature. However, if lack of information is the central problem, there is clearly little role for taxation. It could be argued of course that young people will disregard all information provided, but that given their relatively low incomes they are price sensitive and that the best way to 'protect them from themselves' is by raising the price of cigarettes so high, through taxation, that they simply will not be able to afford to purchase them until they have reached an age when they can make a more informed decision. This brings us into the domain of paternalism, which we consider next.

### Paternalism

It is possible to go outside the economist's framework and decide that, despite the fact that each individual, including young people, might possess all relevant information, and that present levels of taxation are covering all possible costs on the exchequer imposed by smokers, the 'correct' decision is still not being made and that the tax instrument, through raising prices, must be used to bring it about. This philosophy raises some well-known problems such as: 'What is the 'correct' decision? Who decides what it is? Why stop at smoking? These of course are the problems associated with the philosophy of paternalism, which is implicitly invoked by any decision to proceed despite the arguments that have been put forward. It may be claimed, as mentioned earlier, that the possibility of habitual use provides a rationale for intervention of this sort. However, if smokers are aware of the possibility and costs of habitual use, these too will be internalised in their decision. Doubtless this will not satisfy many in the anti-smoking lobby – but, as will be argued later, in the case of habitual use, raising price, through increasing taxation, is both the least effective and most unfair way of coping with the problem for those who already have become habitual users.

### Taxation, Demand and Income Distribution

#### Smoking and Price

It is an odd position to adopt, that in order to discourage younger people from smoking, the price of the product must be raised by imposing higher taxes, thereby penalising all habitual smokers, the nature of whose habit makes it extremely difficult for them to cease consumption in response to the tax hike. This raises the issue of smoking and price and the effect of the latter on the former.

According to the genetic hypothesis, certain factors in a person's make-up may determine a person's psyche and, in turn, the likelihood that they will smoke. In other words, some people may have an underlying tendency to habitual usage of certain substances. If this is true, then it is possible that banning smoking or raising the price of cigarettes, through increased taxation, may simply have the effect of causing smokers to switch to some other such habit, especially the consumption of relatively lower-priced alcohol or soft drugs. Thus the motivations to smoke are varied and complex and it may be that price simply is not a key factor in the decision whether or not to smoke.

It is well known that, at least for small price changes, the demand for tobacco products is inelastic, which means that the percentage fall in quantity demanded resulting from a price rise will be less than the percentage rise. In other words, demand tends to be unresponsive to price – meaning that if a reduction in tobacco consumption is desired, as opposed to simply recouping exchequer costs, then altering the price may not be an effective way of doing it. Indeed, often tax is imposed on these products by governments precisely for this reason, namely that if the tax is increased tax revenue will increase. Habitual use is simply an extreme form of non-price sensitivity – an habitual user will pay large sums to get what he/she wants and as Shoup says: 'If...we put aside the problem of negative externalities, there seems to be no acceptable principle that justifies higher taxation of addicts' (Shoup, 1983, p.263). Payment of such a tax may not be voluntary and, moreover, to maintain expenditure on tobacco, the habitual user will have to spend less on something else, which for the poor will mean less consumption of necessities – which may be unjustifiable on equity grounds (see later).

Demand being inelastic does not of course mean that there will be no fall in demand following a tax-induced price increase: a 10 per cent increase in price for example is likely to lead to a 4 to 6 per cent decline in consumption, *ceteris paribus*. Everything else in the real world, though, is not equal. At the same time as prices might be increased, incomes may be increasing, thereby providing a countervailing force pushing up demand for smoking. It is also possible that if taxes go too high, people may switch from the consumption of legally-sold tobacco to the illicit tobacco trade, with no net reduction in overall smoking. The main effects being a loss of tax revenue to governments and the encouragement of smuggling and illegal selling of tobacco products.

#### Cross-border and Duty-free Purchasing, and Smuggling

There are three ways an individual can continue to smoke manufactured tobacco and avoid paying the special taxes imposed in his/her place of residence. Under the Single European Act of the EU, residents in one member state can effectively purchase unlimited amounts of tobacco, provided it is for personal use, duty paid in another member state. As the duty paid varies very substantially across EU member states (see below), this clearly provides a legitimate way for someone to avoid paying the high tobacco tax in his/her country. There is considerable evidence of such activity in the EU, especially in border areas, something

that, in the absence of EU agreed harmonisation of rates, has prompted market-driven alignment of duty rates in neighbouring member states.

Those travelling across EU boundaries, by air or sea, do not have to pay any duty at all on a fixed quantity of tobacco purchases, thanks to the existence of duty-free shopping. The higher the special tax rates, the more incentive there is to purchase duty-free tobacco. An extension of duty-free shopping beyond the introduction of the single market in 1992, to June 1999, was provided for in the VAT Systems Directive (91/680/EC) and the Excise Directive (92/12/EC). The issue of a further extension, at least for some countries, is still a possibility. The rationale for introducing duty-free purchases is hard to find, but now that a whole duty-free business and an associated rent-seeking lobby have grown up in the interim, its removal will inevitably be hotly contested. Whatever the rationale for imposing special taxes on tobacco, it is hard to see why that rationale would not apply when people are purchasing tobacco as part of a holiday or business trip abroad. Its existence simply undermines the suggested rationale for the existence of the special taxes, adds to the inequitable nature of the taxes, as lower income people would have less opportunity to purchase duty-free tobacco, and lessens the case for a clamp down on the illegal sale of tobacco across the EU.

As with duty-free purchasing, the incentive to sell and buy illegally supplied tobacco is a function of the level of the special taxes that apply. As will be seen later, these levels are exceptionally high in some European countries. Smuggling of tobacco has become big business. Tobacco duty in the EU is only payable at the final destination of the cargo, implying that it can be bought duty-free in another EU state or in a non-EU state, and then sold, if undetected crossing borders, duty-free in the streets or through illegal outlets. Because of the high duty levels that apply, huge profits can be realised through this illegal activity, which for organised crime must be considered a low-risk venture. There are a number of reasons for the low risk. The product is legal and around 40 per cent of EU citizens consume it; people are prepared to purchase contraband because of the huge saving to themselves and because of the perception, perhaps, that since you can buy tobacco duty free at an airport or on a boat, it cannot be that 'illegal'; the scale of the operation, the large number of people involved in the sale of contraband and the relatively low penalties make a major crackdown on the trade unlikely. Smuggling of tobacco, of course, is not just an EU phenomenon but is worldwide (Nicholson, 1994).

All of these outcomes arise from the high level of tobacco duty, and to a lesser extent from the differential tax rates applying in neighbouring

countries. They do not necessarily provide a case against high special taxes on tobacco, but they certainly act as a major constraint on the operation of a high tobacco tax policy in any country.

#### Income Distribution

The biggest constraint on the use of high special taxes on tobacco in some people's opinion arises from the adverse distributional consequences that such a policy entails. It is well known that taxes on tobacco are among the most regressive forms of taxation available to a government. This is because the poor spend a higher proportion of their income on tobacco, and thus any taxation-induced price rise hits them harder than other groups.

Data for the United Kingdom show that expenditure on tobacco products as a proportion of expenditure on all commodities comes to 6 per cent for the poorest 10 per cent of households, but less than 2.5 per cent for the richest 10 per cent of households. Looking at it differently, professionals smoke the least (14 per cent), while unskilled manual workers smoke the most (42 per cent of them smoke). As many as 46 per cent of those unemployed smoke (Nicholson, 1994). This is an EU-wide phenomenon, as evidenced by the following: 'A notable trend is the higher prevalence of smoking in lower socioeconomic groups as better educated, better paid and more health conscious individuals increasingly avoid smoking. This has very important socioeconomic implications. Persons on lower incomes spend a disproportionate amount on tobacco as, due to its addictive properties, it often takes priority over other household expenditure. Expenditure on other items important to health, such as food and housing, suffers accordingly' (Commission of the European Communities, 1996, p.3). Why then, it may be asked, is the European Commission favouring a policy of increases in tobacco tax above the rate of inflation for the foreseeable future?

Contrasts with other forms of taxation highlight the regressivity of tobacco tax. It is quite possible for some of the poorest households in the high-tax countries such as Denmark, Ireland and the United Kingdom to pay as much in tobacco taxes as they do in VAT on all other products, and more than they do in pay-related social insurance and income tax combined. It could be argued of course that examining one particular tax is not relevant because it is the regressivity or otherwise of the overall tax system that counts, and that in particular a progressive income tax will balance out any anomalies on the tobacco side. However, what the poor

gain from the progressivity of the income tax system they may lose, many times over, on the excise front. Such effects lessen considerably the supposed redistributive impact of the state welfare system.

The above paragraphs dealt with the issue of vertical equity, the principle being that the higher your income, the higher should be the percentage of your income that is paid in tax. There remains a less well-documented issue – that of horizontal equity – involving the principle that people on similar incomes and in similar circumstances should pay the same tax. That this principle is very seriously violated in the case of tobacco can be seen by examining the different taxes paid by people on similar income levels, assuming different levels of consumption of cigarettes. Take two people each on the average industrial wage, of whom one does not smoke and the other smokes 40 cigarettes a day: the non-smoker clearly would pay nothing in excise duties whereas the smoker could pay as high as 8 per cent of his/her total income in such taxes.

The inequity of tobacco taxes is seen at its clearest when politicians claim that six or seven out of ten people are in favour of increasing taxes on tobacco. This is not surprising: six or seven out of ten people in the EU do not smoke and therefore do not pay tobacco tax. Increasing tobacco tax therefore is an 'ideal' tax for them: if it is increased the burden will not fall on them. It could of course be argued that, as seen earlier, the tax on tobacco is simply a premium to pay for the costs that smokers impose on the exchequer. As such, the issue of equity does not arise at all, as smokers are not being taxed to fund general expenditure but simply expenditure that arises directly as a result of their consumption. As noted earlier, though, it is not clear at all that over, say, 30 years, smokers do impose a significant net cost on the exchequer, there may even be a net saving. Moreover, given the addictive nature of tobacco consumption and the fact that the better educated and higher income persons are best able to cope with quitting the habit, is it equitable to make lower-income smokers effectively pay for their health care in full, through the imposition of high excise taxes on the consumption of tobacco? The real reason for special taxes on tobacco appears to lie elsewhere: the revenue raising potential of such taxes.

#### The Structure and Level of Taxation and EU Harmonisation

At present three principal forms of taxation are levied on tobacco products in the member states of the EU – value added tax, a fixed specific excise duty and a variable *ad valorem* excise duty. It is only the last two

that are special to tobacco, as VAT is applied to most consumer goods and services.

One thing that is evident from Table 2.1 is the enormous variation in price across the EU of the most popular category of cigarette. As can be seen, it varies from a high of 181 Ecu in Denmark to a low of 36 Ecu in Spain. These differences are largely explained by the different tax levels applying in each country, but not wholly so. Column 2 of Table 2.1 outlines the non-tax price of the most popular brand and as may be seen this varies from 38 Ecu in Ireland and the UK to 12 Ecu in Portugal and Spain: these differences could be explained by three factors: variation by country in the quality (and therefore cost) of the most popular brand, variation in ex-factory price for the same cigarette quality, and variation in retailers' margin. These differences are not the concern of this paper though they are relevant to the tax issue where the taxes are *ad valorem*, as is the case with VAT and the *ad valorem* tobacco duty. The lower the non-tax price, the lower will these taxes be in absolute terms, even when the rates are the same across countries.

Table 2.1 Cigarette Prices and Taxes in EU Countries, 1994

Country	Current most popular price category per 1,000 cigarettes in Ecu	Net of tax price	Total tax yield, in Ecu per 1,000 cigarettes	Specific excise in Ecu
Belgium	111	28	83	9
Denmark	181	28	153	79
France	10	42	67	84
Germany	128	36	92	44
Greece	82	23	59	3
Ireland	152	38	114	62
Italy	78	21	57	3
Luxembourg	79	25	54	3
Netherlands	103	29	74	37
Portugal	66	12	54	7
Spain	36	12	24	2
United Kingdom	161	38	123	67

As may be seen in Table 2.1, the total tax yield varies from 24 Ecu in Spain to 153 Ecu in Denmark, and this is mostly explained by the different specific excise duty (2 Ecu in Spain and 79 Ecu in Denmark). There is a huge variation in the specific excise rates across member states, and there has been almost no progress in harmonising these rates over the last

twenty-five years, despite efforts to do so. Failing this, the EU has tried to harmonise the structure of cigarette taxation, again with very limited success.

The first two columns of Table 2.2 illustrate that the reliance on *ad valorem* and specific excise duties varies hugely by member state. However, looking at Column 3 it can be seen that when the two taxes are taken together, they vary relatively little when expressed as a proportion of the selling price: from a low of 55 per cent in Spain to a high of 67 per cent in Portugal. It is on this ratio that there has been some progress in the EU: it has been agreed that this ratio should not fall below 57 per cent. Spain having been given an extension beyond 1994 to achieve this figure. However, there has been almost no progress on the split of this ratio between specific and *ad valorem* elements and the huge variation across member states remains. It was agreed that the specific tax as a proportion of the total tax take on tobacco should fall within a set range (see last column of Table 2.2), but this range was set at such a broad level, between 5 and 55 per cent, it is almost meaningless. As may be seen all countries fall (just) within this range, but no progress has been made in the last twenty-five years in narrowing the permitted range.

Table 2.2 Cigarette Taxes in EU Countries, 1994

Country	<i>Ad valorem</i> excise as % of retail selling price	Specific excise as % of retail selling price	Sum of first two columns	Specific excise as % of total taxation (excise plus VAT)
Belgium	50	8	58	10
Denmark	21	43	64	51
France	55	4	59	6
Germany	25	34	59	47
Greece	53	3	56	5
Ireland	17	41	58	55
Italy	53	4	57	5
Luxembourg	54	4	58	5
Netherlands	21	36	57	50
Portugal	56	11	67	14
Spain	49	6	55	9
United Kingdom	20	42	62	54

The issues that the structure of tobacco tax between *ad valorem* and specific elements raises were examined in detail by Kay and Keen (1982) over 15 years ago and most of what they wrote then is still relevant given that almost no change has been effected in the intervening years in the

structure of tobacco tax. Their conclusions were clear. The EU should attempt to harmonise the *ad valorem* tax rate (i.e. Column 2 in Table 2.2) but given that each country relies to a different extent for tax revenue purposes on tobacco tax the EU should let the specific tax element vary across countries. The reason Kay and Keen favoured the harmonisation of the *ad valorem* rates is that it is this aspect of tobacco taxation, they argue, that affects market structure and conduct in the tobacco trade and that it is desirable to harmonise these aspects of the industry across member states in order to ensure a single market. The issue why there should be an *ad valorem* element at all, though, was not addressed. However, if the view is taken that it is appropriate to tax tobacco because of its detrimental effects on health, then it would appear that specific excises are more appropriate given that it is the quantity rather than the value of the product that matters most from a health point of view.

#### Conclusion

This paper has addressed a number of issues. The rationale for special taxes on tobacco was considered and it was illustrated that the case is not nearly as clear-cut as is sometimes assumed. There are clearly informational problems in relation to smoking, given the long-term nature of some of the costs and the addictive nature of the product. These, however, do not suggest any role for taxation, but point to better information on packaging, restrictions on advertising and promotion, and educational programmes, in particular for young people. If people still choose to smoke given these measures, then their free choice to do so must be recognised and not penalised through special taxation measures. If it is felt that taxation, and therefore higher prices, discourage young people, because of their limited incomes and the fact that they are not yet addicted to the product, a more sensible approach would be to ban altogether the sale of cigarettes to those under a certain age and not add further to the financial problems of those already addicted to the product, mostly people on lower incomes.

The fact that smoking confers costs on non-smokers was also considered. The major such cost are costs to the exchequer in terms of increased health bills and disability benefits, but because smokers die younger these must be offset by reduced pension and other payments by the state. Hence, no precise measure of the exchequer cost of smoking, if any, appears to be accepted. The main rationale in practice for the special taxes appears to be to raise revenue. One cost, though, that is real and has



caused considerable controversy, is the cost of passive smoking: not just the increased risk of cancer from passive smoking, but the general unpleasantness of the atmosphere created for non-smokers by the presence of smokers, especially in a confined space. There have been several legal and other measures introduced to reduce the level of such costs to non-smokers, but here again there is no real role for taxation measures.

The real reason for special taxes on tobacco in most countries appears to be the fact that they provide a relatively easy source of tax revenue. Demand for the product is relatively inelastic and politically they appear to be a popular tax. Herein lies the first real problem with tobacco taxes as a revenue-raising device: they are paid for entirely by smokers, thereby allowing non-smokers to avoid completely paying any of these taxes. This is hugely inequitable between smokers and non-smokers, and also across income groups, as those who smoke come predominantly from the lower income classes. Another problem with relying on tobacco taxes as a revenue source is that, if set at too high a level, they may lead to cross-border purchasing, legal and illegal. It is the latter that is now of particular concern, especially in Europe.

Apart from the level of the taxes, the chapter concluded with some discussion about the structure of tobacco taxes in the EU. It was seen that not only is there huge variation in the rates of specific taxes on tobacco, but that there is equally large variation in the structure of tobacco taxes as between specific and *ad valorem* rates. Any country seeking to reform its tobacco taxation needs to take account of the complex range of issues outlined above.

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