

# TAXATION AND PRICE

## Types of taxes

Raising tobacco prices through tax increases is a very effective way to reduce tobacco use. There are three different types of taxes generally applied to tobacco products: **specific** excise, **ad valorem** excise, and value-added tax (VAT).

### EXCISE TAX

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Excise tax is a tax on selected goods which are produced within a country, or imported and sold in that country. Tax can be collected from the producer, manufacturer, wholesaler, importer, or at the point of final sale to the consumer. Excise taxes can be either **specific** or **ad valorem**. **Specific** excise taxes are charged per quantity, such as per cigarette, pack, or kilogram (e.g., \$1.50 per pack regardless of price). **Ad valorem** excise taxes are 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 retail price).

### SPECIFIC EXCISE TAX

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#### ADVANTAGES

- **Predictable.** Because the tax is not sensitive to changes in price, tax revenues do not change when manufacturers change prices. The government revenue is therefore protected against industry's price wars or price manipulations. Government can predict tobacco tax revenue based on tobacco demand.
- **Raises all product prices.** Specific taxes are fixed and do not depend on tobacco industry pricing strategy. In addition, since the tax is, in most cases, applied to all products at the same rate, a higher tax usually results in similar prices increase across the board, regardless of product.
- **Easier to administer.** Costs of administering specific excise taxes are low because it is easier to count the number of products than to estimate their value. Unlike the VAT tax, which is collected at many points of production, specific taxes are only collected once, either from producers/importers or from retailers, thus making tax evasion less likely and collection more efficient.
- **Easy to determine value.** It only requires a precise definition of what constitutes "one unit" or quantity.

#### DISADVANTAGES

- **Inflation erodes its value.** Because the tax rate is not tied to the product price, it does not automatically adjust with inflation. Instead, the government must periodically implement additional rate increases, or add into the tax law that the specific excise tax rate will automatically adjust with inflation.
- **Can be reduced by changing products characteristics.** Tobacco industry can reduce the impact of specific taxes on consumption by, for example, producing bigger or longer size cigarettes if the tax is applied per stick, or by increasing the size of a pack if the tax is per pack.

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## AD VALOREM EXCISE TAX

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### ADVANTAGES

- **Automatic adjustment for inflation.** Since the tax is tied to the product price, the tax automatically adjusts with inflation.
- **Higher profit margin is taxed.** Ad valorem tax reduces the industry profit margin since a part of any price/profit increase goes to the government as tax revenue.

### DISADVANTAGES

- **Less predictable revenue stream.** As ad valorem taxes are based on value, it is difficult to predict tax revenue over time.
- **Difficult to determine value.** As opposed to specific taxes, which can easily be applied to products merely by determining the quantity, ad valorem taxes require more effort to calculate the payment. Manufacturers can easily manipulate their product prices to avoid higher tax payments.
- **Low prices.** There is an incentive for manufacturers to produce low-priced products because ad valorem taxes are tied to product prices. This, in turn, makes the products more accessible to youth and other low-income populations.
- **Leads to large price differences between products.** Ad valorem taxation widens the gap in prices between cheap products and more expensive products. More smokers may purchase cheaper products or switch from the more expensive products to cheaper ones, and this may reduce the impact of higher tax on consumption.
- **Difficult to administer.** Auditing the value of multiple types of tobacco products declared by the manufacturers requires strong tax administration capacity. In countries where tax administration may be weak, the full tax revenue potential may not be realized if the market prices are not well established or verified.

## VALUE ADDED TAX

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Value added tax (VAT) is a general tax on consumption of products and it is applied proportionally to their prices. VAT is charged as a percentage of the value added/generated at each stage of production. For instance, tobacco growers and cigarette manufacturers are each charged a tax on the value they add/generate to the total value of a cigarette.

### CONCLUSION

- In most low/middle-income countries, **specific** taxes that automatically adjust for inflation should be preferred to **ad valorem** taxes.
- **Specific** taxes minimize substitution and are more effective than **ad valorem** taxes at reducing consumption after a tax increase.
- The **specific** tax is easier to administer and assures a predictable income for the government.
- **Specific** excise tax should be adjusted such that the nominal retail price of cigarettes increases by at least the sum of the inflation rate and the per capita income growth rate.

#### Sources:

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