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Tobacco Taxes in Latin America

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EFFECTIVE TOBACCO TAXES IN LATIN AMERICA: RECOMMENDATIONS BASED ON NATIONAL EXPERIENCES

tobacconomics

Economic Research Informing Tobacco Control Policy

This Policy Brief presents the main policy recommendations emerging from the background studies (Argentina, Brazil, Ecuador, Mexico and Peru) and the comparative regional report of the project "Tobacco Taxes in Latin America" coordinated by the South American Network on Applied Economics/Red Sur as part of the global project coordinated by the Institute for Health Research and Policy of the University of Illinois at Chicago (UIC), supported by the Bloomberg Initiative to Reduce Tobacco Use.

TOBACCO CONSUMPTION IN LATIN AMERICA

Much like the rest of the world, smoking prevalence in the Americas has dropped substantially in the past decade. Between 2007 and 2015 smoking prevalence decreased from 22.1% to 17.4%, a reduction of 4.7 percentage points, which is more than the global reduction. However, the distribution of smokers by sex in Latin America shows smaller differences than the international ratio of 5.8. As shown in Table 1, this ratio varies widely. In some cases, like Peru, consumption among young men and women is very similar (10.9% and 8.4%), while in others such as Mexico, the percentage of male smokers is three times that of female smokers, and in Ecuador is two and a half times higher.

Table 1.- **Current consumption of smoked tobacco (%) in adults, unless otherwise stated**

Country	Men	Woman	Relationship	Total
Argentina*	29,9	20,9	1,4	21,5
Brazil	18,9	11,0	1,7	14,7
Ecuador	38,2	15,0	2,5	31,5
Mexico	25,2	8,2	3,0	16,4
Peru**	10,9	8,4	1,2	9,7
World			5,8	

Note: **Refers to current cigarette consumption (%) in adults. **Refers to current tobacco consumption (with and without smoke) (%) in young people.
Source: Report on Tobacco Control in the Region of the Americas, 2018 - situation of tobacco control by country, PAHO. https://bit.ly/2TxjH73

According to the Pan American Health Organization (PAHO/WHO), prevalence rates in the countries studied (Argentina, Brazil, Ecuador, Mexico and Peru) range between 10% and 31% of the total population. Argentina, Brazil and Peru follow the global pattern, characterized by a concentration of the number of smokers in poorer sectors with lower educational levels, whereas Mexico and Ecuador are exceptions to this pattern.

Every year, tobacco use is responsible for US$33,576 million in direct healthcare costs in the region (Pichon-Riviere, A. *et al.*, 2016). A significant part of health spending is financed with public funds from direct public provision or contributory social insurance schemes. This share is as much as 61% in Peru, 55% in Argentina, 52% in Mexico, 49% in Ecuador, and 46% in Brazil[1]. Therefore, tobacco use has a significant impact on the fiscal policy space of each country. Healthcare costs attributable to tobacco use represent 0.7% of the GDP in the region and 8.3% of health budgets. The cost attributable to tobacco use ranged between 0.4% (Mexico and Peru) and 0.9% (Chile) of GDP and between 5.2% (Brazil) and 12.7% (Bolivia) of public healthcare spending[2]. Yet, in the region, tax revenue from the sale of cigarettes barely covers 37% of healthcare expenditures attributable to smoking (8.1% in Bolivia and 67.3% in Argentina) (Pichon-Riviere, A. *et al.*, 2016). On the other hand, when expenditures are not covered by public funds, direct costs for healthcare can be a devastating expenditure for low-income households[3].

TOBACCO TAXATION STRUCTURES IN LATIN AMERICA

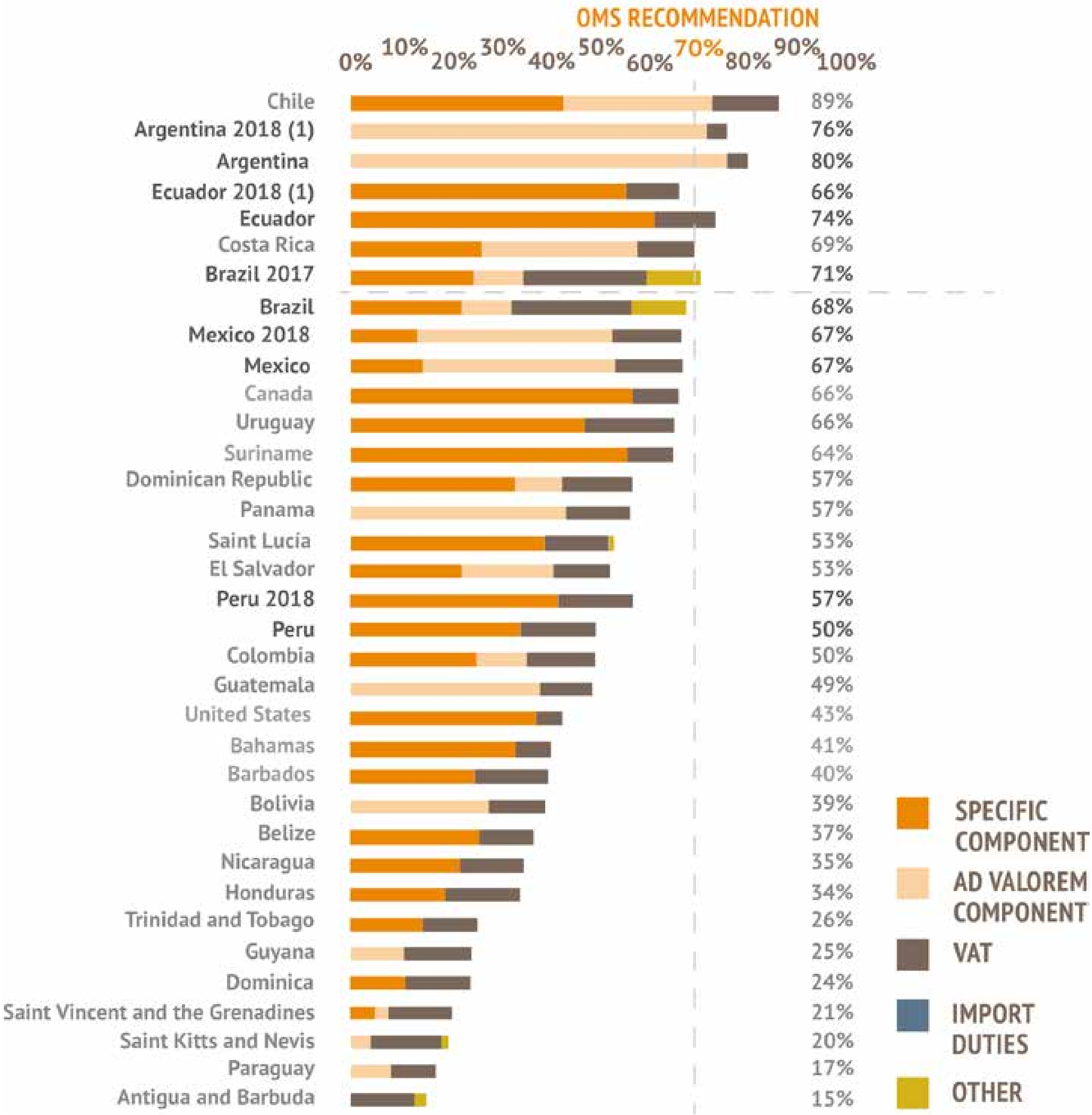
As is often the case when analyzing Latin American countries, it is not possible to find a common pattern of tobacco tax structures. As shown in Figure 1, there is a wide range of tax burdens on cigarettes as a percentage of the final price. Even though the countries which are covered by this regional project are among those with the greatest relative burden on the final retail price, retail prices are still low in many in terms of international standards, and affordability has increased in some of the selected countries.

1> WHO, see **https://bit.ly/2JebK1J**

2> Report on Tobacco Control in the Region of the Americas, 2018 - situation of tobacco control by country, PAHO. **https://bit.ly/2TxjH73**

3>A household with catastrophic health-related expenses is defined as one allocating more than 30% of their ability to pay to financing their members' health: **https://bit.ly/1eQntzw**

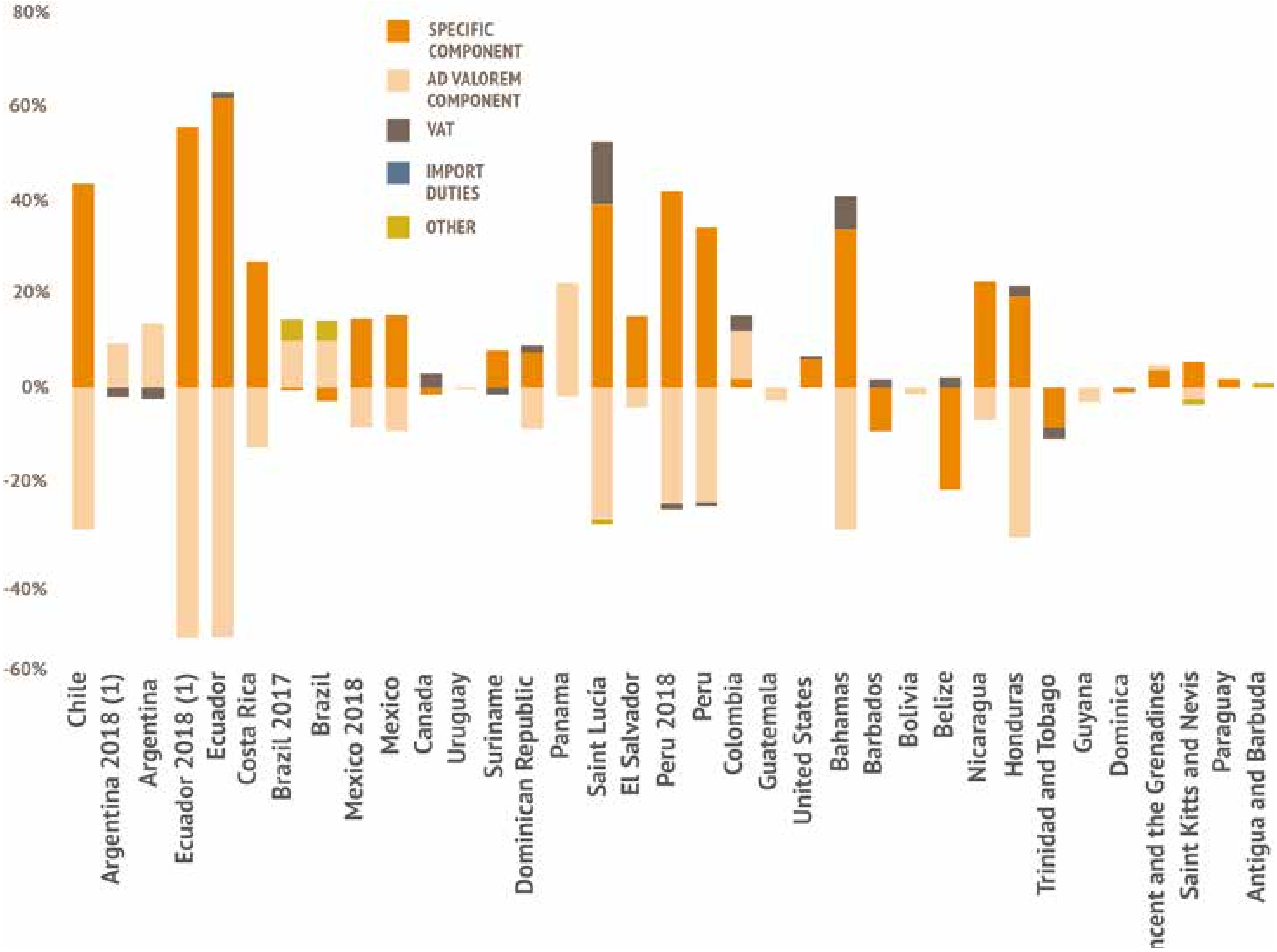
Figure 1.- **Structure of taxes on cigarette consumption (% of the price of the best-selling brand, 2016)**[4]



Source: Author's elaboration based on information from the project studies and the World Health Organization.
See https://bit.ly/2HhFt8m

Figure 2 shows the variation in the percentage of the retail price of tobacco disaggregated by the variations in the tax components between 2008-2016 and helps to identify changes in the tax structure for all the countries in the sample.

Figure 2.- **2008-2016 variation of the structure of taxes on cigarette consumption (% price of the best-selling brand)**[5]



Source: Author's elaboration based on information from the project studies and the World Health Organization. See **https://bit.ly/2QyaUzp** and case studies of the project.

4> (1) With respect to Weighted Average Price (WAP) Argentina: Average retail price as of June 2018. Ecuador (2018): Suggested annual average retail price 2018; Brazil (2017): 2017 price of the leading brand "Derby" based on 2018 Euromonitor information; Mexico (2018): 2018 annual price according to Ethos methodology (2018) table 7.1; Peru (2018): Weighted average price as of November 2018 of the three best-selling brands (Pall Mall, Hamilton, and Lucky Strike) according to information on average supermarket retail price of the best-selling brands (IEP, 2018 - Table 2).

5> Ibid.

Implementation of the main tobacco tax policies recommended by the Framework Convention on Tobacco Control (FCTC) are observed in **Ecuador**, Mexico and Peru; as Brazil already had a specific component since 1999, while Argentina taxes these products mostly on an ad valorem basis. In the case of Ecuador, the change towards specific taxation occurred in 2012, when there was a 150% ad valorem rate for cigarettes that had been in place since 2007 was abandoned and replaced with a specific value of US$ 0.08 per cigarette, which increased gradually in real values until it reached US$ 0.16 as of May 2016, and then, with an inflation adjustment clause since 2017[6]. The study of *Pontificia Universidad Católica del Ecuador (PUCE)* within this project analyses the emblematic case of Ecuador, where even though the final price of cigarettes is not heavily affected by taxes, it has the highest price per pack in the sample in Figure 2, with a 170% increase in purchasing power parity since 2008. A gradual reform that doubled the excise tax between 2011 and 2016 was accompanied by a fall in cigarette sales 2016 and 2017. This decrease in cigarette sales (sales fall from US$ 233.7 million to US$ 154.9 million in 2017) produced a decrease in tobacco tax revenues. Recently, Ecuador implemented a track and trace mechanisms that will provide a more accurate measure on the variation of sales in terms of units. PUCE preliminary simulations indicate that an increase in the excise tax up to 69% of the final sale price (US$ 0.27 per unit) would change current consumption (from 55 million) to 12 million cigarettes.

In the case of **Mexico**, the total burden in 2018 on the retail price of a pack of 20 cigarettes is as much as 67%, with 39.6 percentage points accounted for by the ad valorem tax; another 13.4 points are added as a specific component; and finally VAT completes the tax burden with 13.8% of the total. Mexico has not updated the specific tax since 2011 (160% of the manufacturer price plus $0.35 Mexican pesos per cigarette); it has no adjustment mechanisms. The commitment was extended through the Tax Certainty Agreement from 2014, as indicated by ETHOS study within the project.

In the case of **Peru**, since 2010, the tax structure has been the General Sales Tax (GST), plus a Special Consumption Tax (SCT). The tax burden on the weighted average price of a pack of cigarettes is approximately 57%[7], made up of 15 points of general sales tax and 42.1 points of the SCT since May 2018[8].

6> However, it should be noted that the previous ad valorem treatment persists for tobacco substitute products, whose sale is marginal within the country.

7> It should be noted that the increase shown in the forgoing charts may be inaccurate inasmuch as there are great differences between the price of the best-selling brand and the price obtained as a weighted average.

8> Due to the specific nature of the tax, this weighted average shows wide variance depending on the retail prices observed in the different brands. For instance, for the brand PallMall, with a price of S/ 10 per pack, the specific tax is as much as 54% of the price, and the total burden is 69%, while in the case of Lucky, the values are 33.8 and 48.8%, respectively.

The report of the Institute for Peruvian Studies (IEP) within this project indicates that after substitution of the specific component, the tax increases were transferred to the final prices of cigarettes, with cases of overshifting close to 20%, and at the time of closing the research, a possible overshift could not be ruled out for 2018.

In the case of **Brazil**[9], although there have been no major reforms in recent times, there is a widely distributed burden within the federation that – if one looks at the highest rates of its State VAT (State Tax on Circulation of Goods and Services, ICMS) and its 2% municipal surcharge, allocated to fighting poverty – can reach an effective rate of 78% on the retail price of the best-selling category in Brasilia, in contrast with 10 percentage points lower in the state of Rio Grande do Sul. At the federal level, four other taxes are applied at the beginning of the production chain, in addition to the application of a minimum price as of 2011[10]. Among these four taxes is the excise tax on industrialized products (IPI), which is the main excise tax[11], with a general ad valorem rate of 45%[12] and another special rate option[13]. At present, all of the producers choose the special rate option because it makes it possible to take a greater proportion of the price increases (research within this project conducted by Fundação Centro de Estudos do Comércio Exterior – FUNCEX).

Finally, the case of **Argentina** also presents a scheme with multiple ad valorem excise taxes on tobacco products (see footnote 14), various specific allocations and overlaps of taxable incomes which form a complex framework[14] made up of four components[15]. The Instituto Torcuato Di Tella - ITDT study within this project analyzed the last two amendments to the Internal Tax, the first in May 2016 and the second in December 2017. However, the second reform that came into force in 2018 was only partially implemented because different court actions allowed some packs of 20 cigarettes to be sold below the minimum tax[16]. The modification to the ad valorem component from 75% to 70% reduced the total burden on the average retail price of cigarettes to 76% as of 2018[17].

9> FUNCEX (2019).

10> Secretaria da Receita Federal do Brasil (SRFB) and Law 12546 of 2011.

11> The other three taxes are: the tax for the funding of the Social Integration Programme (PIS); the Contribution for the funding of Social Security (COFINS); and import duties.

12> As a result of the existing 300% rate on a calculation basis of 15% of the retail price.

13> A nominal ad valorem rate (on the same calculation basis of the general rule) and a specific rate, both increased progressively until they now reached 66.7% (10% effective) and R $ 1.50 since December 2016.

14> ITDT (2019) and iDeAS - UNSAM (2019).

15> *Rate within* means that a nominal rate of 70% turns into an effective rate of 233% through the following formula: EFFECTIVE RATE = (100 x t)/(100 - t), with "t" being the legal or nominal rate of the tax.

16> In regard to the brands that secured court protection as of 2018, it should be noted that as a result of the measure they are not affected by all of the reform, but only by the previous ad valorem rate of 60%, so they are benefited as regards both the application of the minimum price and the increase in the internal tax rate.

17> The study carried out by ITDT found that the increase in the ad valorem tax of May 2016 had an immediate impact of around 50% on the average price, although this increase lessened in real terms before the next reform of December 2017. As the minimum tax reform could not be fully implemented, no convergence is observed in the evolution of the price gap series between expensive and cheap brands.

RESEARCH FINDINGS AND POLICY RECOMMENDATIONS

Most of the estimates made as part of this project indicate that the price elasticity of demand is less than one and the value of this parameter is between -0.40 and -0.50, which implies that **a 10% increase in the retail price of tobacco would result in a reduction of between 4% and 5% in the amount consumed.** Therefore, the tax increase would be compatible with an increase in total revenue from the tax. In other words, reforms in the countries in the region should result in significant increases in the tax burden leading to considerable increases in the relative price of these products, if the goal is significant reductions in consumption.

Moreover, strategies that seek to increase the effectiveness of tobacco tax policies should also focus on controlling illicit trade and replacing incentives for growing tobacco to alternative crops.

In the case of Argentina, the **ITDT** study suggests that because of evident institutional pressure through writs of protection through which opponents of the tax have managed to thwart attempts to implement minimum taxes, it is more efficient in the short-run to increase the ad valorem tax rates, as it may produce more immediate results on cigarette consumption and tax revenue. The Centro **iDeAS - UNSAM** study concludes that any possibility of supply-side interventions to complement efforts to reduce tobacco consumption requires gradual progress on different fronts. Some examples of action that could be taken without the need for substantial changes to the Special Tobacco Fund (FET) are: i) Improving the use of the funds that benefit small producers; ii) Prioritizing productive diversification

rather than restructuring projects; and iii) Extending the benefits of the FET for a period of 3 to 5 years after stopping operations as a tobacco producer. Some additional further-reaching actions could involve: i) Implementing a comprehensive regional development programme that includes – but is not limited to – the restructuring of tobacco production; ii) Conducting a campaign aimed at raising awareness among producers of the worldwide trend towards a reduction in tobacco consumption; iii) Considering a possible increase to tax withholdings on tobacco exports as a means of countering the encouragement for traders and limiting the incentive to expand production/exports; and iv) Amending legislation in order to turn the FET into a co-participatory tax resource for the producing provinces.

However, the presence of illicit products threatens the effectiveness of public health efforts and makes the assessment of the tobacco market considerably more complex. The illicit cigarette trade in Brazil undermines the capacity of the State to fight the tobacco epidemic in the country, since total cigarette consumption is unknown. Therefore, FUNCEX proposed creating a track and trace mechanism on inputs for the manufacture of cigarettes, and to strengthen law enforcement on illicit activities to control not only illicit trade but also illegal production and tax evasion.

In the case of Peru, **IEP** proposes a predetermined mechanism for constant SCT increase of approximately two percentage points above the average inflation of the last decade (3%) in order to have a tax burden of 70% of the retail price by 2030.

The recommendations emerging from **PUCE**'s study are that the IRS's capacities should be strengthened in order to estimate the evasion gap and that other public institutions should join the control process for improved efficiency in Ecuador. In this regard, it is necessary to support the implementation of the System for Identification, Marking, Authentication, Tracking and Tax Traceability (SIMAR) as well as work on the supply side through the implementation of public policies that discourage production.

In the case of Mexico, **ETHOS** stresses that the effectiveness of the Special Tax on Production and Services (IEPS) has been eroded over time, since it has both an ad valorem and specific tax component, and failure to update the latter since 2013 has led to a significant loss in revenue. The healthcare costs related to tobacco use are so high that the revenue from the IEPS only covers half of them, excluding the activities that seek the prevention and elimination of tobacco consumption.

Therefore, a higher tobacco tax is proposed that should be periodically updated at a greater rate than inflation in order to reduce cigarette affordability, both as an incentive for people to smoke less, and to reduce the burden of smoking on public finances. ETHOS proposes linking the collection of tobacco taxes with the prevention, cessation and treatment of diseases caused by the consumption of this product, and redesigning the budget structure related to tobacco control, designing specific indicators to determine the effectiveness of each of the actions taken by the state and measure how efficiently public resources are used in the fight against smoking.

The Centro de Investigación en Alimentación - **CIAD** study within this project finds that while indirect taxes currently account for 67% of the price of tobacco in Mexico, this burden remains below the 75% recommended by the World Health Organization (WHO). Furthermore, it is essential for the specific component of the special tax to be updated with inflation, so that it does not lose its reduction effect on consumption over time. The study also recommends increasing both IEPS components to reach the tax burden suggested by the WHO (260% and 0.80 pesos) by increasing the ad valorem component to 240% and the specific component to 2.35 pesos. The reform of the IEPS should increase the amount of the specific component in a greater amount than the ad valorem rate because the specific tax: a) is required to be updated above inflation periodically; and b) produces a greater reducing effect in consumption. Unlike in other countries, prevalence among the poor in Mexico is the lowest (less than 5%) in the population. In the case of Mexico, the sensitivity of demand for tobacco products is lower among lower income groups. As a result, most tax revenues come from the highest decile, due to the greater smoking prevalence rates among people in this income decile (that is, a progressive redistributive effect is observed). CIAD recommends also to strengthen national health programmes against smoking-related diseases, expanding healthcare coverage through the existing Seguro Popular (which does not include them at present), and to assign a transfer to population groups living in chronic poverty (consisting of a food basket with the most consumed foods among the poor: eggs, beans, milk and tortillas) through food stamps.

Some of the studies developed under this project suggest earmarking for the health sector, in general, or to specific programs such as cessation of tobacco consumption, all or part of the funds collected by tobacco taxation. This issue, however, represents a challenge, since fiscal policy authorities may generally argue that it is not convenient to pre-allocate tax revenues.

It is important to recognize that the disparities in tax pressure observed in the countries analyzed, together with the overall regressive nature of the tax systems and the distortions caused by some of the tax instruments widely used in Latin America, determine particular political economy contexts that must be taken into account when analyzing the viability of tobacco tax increase initiatives. A substantial increase in indirect taxation on cigarette and tobacco consumption can hardly be achieved without an initiative from the **Executive** and without the parliamentary representatives perceiving the proposed project as a **political priority** for the government. In this context, and in the case of a tax initiative with health motivations, it is important to ensure compatibility of interests between Health and Finance Ministries. The adoption of measures to improve control over these activities and greater enforcement of corporate tax obligations in the sector appear as fundamental to ensure that the increase in taxation on tobacco consumption will actually generate more resources for public finances. Therefore, the **strengthening of the control and collection capacities of states** is a fundamental element for progress in these reforms.

However, while tobacco taxation is one of the most effective policies for the objective of reducing tobacco consumption, policy effectiveness can be enhanced **if other initiatives are used simultaneously,** such as the limitations to cigarette and tobacco consumption in public spaces, bans on smoking in educational centres and workplaces, policies on product labelling, limitations to the use of advertising on television and in public spaces, which have proven to be useful tools in other Latin American countries for reducing consumption and raising awareness of these reforms. Health policies should introduce additional measures apart from tax increases, so that the Parliament does not perceive a half-hearted commitment to the initiative on the part of the Ministry of Health. If this happened, doubts would arise about the priority of the project from the point of view of health objectives and the initiative would be discussed in Parliament exclusively from the fiscal point of view, which could jeopardize the approval of the tax reform project.

From the political economy point of view, there are issues related to **fiscal federalism** that must also be considered as they take on special significance when the provision and funding of public health services are in the hands of provincial or local governments (such as the case of Argentina). To ensure progress in the reform, mechanisms should be carefully defined for **co-participation in the collection of the new tax or the increase of the existing tax**, and, if necessary, a specific distribution rule should be established that considers the way in which the different local governments are being affected by the initiative. In tobacco and derivatives producer- countries, consumption reduction policies are faced with the additional challenge of **productive restructuring** of businesses that are usually in the hands of small producers in areas of low relative development and highly vulnerable social conditions. Examples of this situation are Argentina and Brazil, and, to a lesser extent, Ecuador. Tobacco fiscal reforms are viable, but it is a necessarily long, gradual and complex process which should **involve producers seeking new partnership and recruitment modalities that may replace the incentives offered by the tobacco chain.**

The effectiveness of indirect taxes to reduce cigarette and tobacco consumption may depend on **customs control effectiveness.** This is particularly significant in countries where there is no tobacco farming and in countries bordering others that produce raw materials at low cost. In this regard, the experiences of Brazil, in its relations with Paraguay, and the case of Ecuador, encourage us to look more deeply into the possible illicit relations within the tobacco production chains. Therefore, an in depth look at the Paraguayan tobacco complex is recommended to fully understand the situation of tobacco production and consumption in the region, especially in the Mercosur area.

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Within this global initiative, Red Sur led the regional research "Tobacco taxes in Latin America", which mobilized seven research centers to study the different options for tobacco tax policies in Argentina, Brazil, Ecuador, Mexico and Peru.

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No.	Country Study title	Research Team	Center/Country
1	Accelerating effective tobacco taxes in Argentina: **The impact of tax reforms**	Martín González-Rozada and Julio Berlinski	Instituto Torcuato Di Tella (ITDT/Red Sur) **Argentina**
2	Accelerating effective tobacco taxes in Argentina: **Fiscal and productive aspects**	Ricardo Rozemberg, Gabriel Bezchinsky and Ariel Melamud	Centro iDeAS, Universidad Nacional de San Martín (UNSAM) **Argentina**
3	Accelerating effective tobacco taxes in Brazil: **Trends and perspectives**	Livio Ribeiro and Vilma Pinto	Fundação Centro de Estudos do Comércio Exterior (FUNCEX/Red Sur) **Brazil**
4	Accelerating effective tobacco taxes in Peru: **Towards sustainable policies**	Carlos De los Ríos, Hugo Córdova and Marco Ugarte	Instituto de Estudios Peruanos (IEP) **Peru**
5	Accelerating effective tobacco taxes in Ecuador: **The impact of tax policy**	Pedro Páez, Paola Minda, María Dolores Almeida, Ximena Amoroso and Sebastián Burgos	Pontificia Universidad Católica del Ecuador (PUCE) **Ecuador**
6	Accelerating effective tobacco taxes in Mexico: **Tax policy and health costs**	Claudia Córdova, Rodrigo Bolaños, Dalia Toledo, Alejandro Alegría and Liliana Alvarado	Laboratorio de Políticas Públicas (ETHOS) **Mexico**
7	Accelerating effective tobacco taxes in Mexico: **Special taxes, consumption, inequality and poverty**	Luis Huesca, Linda Llamas, Cuauhtémoc Calderón and Abdelkrim Araar	Centro de Investigación en Alimentación y Desarrollo (CIAD) **Mexico**

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