

Policy Brief N° 4/2019

Tobacco Taxes
in Latin America

PERÚ

ACCELERATING EFFECTIVE
TOBACCO TAXES IN PERU:
TOWARDS SUSTAINABLE POLICIES

This Policy Brief was prepared by Red Sur and presents the main policy recommendations emerging from the baseline study for Peru by the Institute of Peruvian Studies (IEP), in collaboration with the Comisión Nacional Permanente de Lucha Antitabáquica (COLAT), as part of the Red Sur-UIC project “Tobacco Taxes in Latin America,” coordinated by The South American Network on Applied Economics (Red Sudamericana de Economía Aplicada, 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), and supported by the Bloomberg Initiative to Reduce Tobacco Use of Bloomberg Philanthropies.

INTRODUCTION

Peru participated actively in the process of developing and negotiating the WHO Framework Convention on Tobacco Control (FCTC), adopting it in 2003 and approving it in 2004. Since then, the country has undergone a number of tobacco-related tax changes in order to conform to the FCTC. During this continuous process of adapting to promote public health, Peru has made significant progress in terms of taxes on tobacco products.

The main objective of this research was to identify a tax strategy for reducing the high social and economic costs related to smoking in Peru, in keeping with the recommendations of the World Health Organization (WHO). The study used information on the amounts of tobacco consumed (apparent consumption) that are econometrically related to prices, the income of the population and a set of variables that help to capture the effect of non-tax policies (such as the implementation of the FCTC agreement). With this information, and taking account of the industry's recent behaviour after the changes in taxes, tax policy scenarios were simulated that could help progressively reach the level of tax burden required to achieve the WHO objectives.



TOBACCO USE IN PERU

According to the Pan American Health Organization (PAHO, 2018), the prevalence rate among young people by sex in Peru is 10.9% for men and 8.4% for women, with a ratio of 1.3 male smokers per female smoker. At the global level, this ratio is as much as 5.8 men per every woman. Peru follows the pattern usually observed worldwide, characterized by the number of smokers concentrated in the poor sectors with lower educational levels. 61% of health spending uses public funds from direct public provision or contributory social insurance schemes, so tobacco consumption has a significant impact on the economy at the fiscal level. The cost attributable to smoking in Peru is 0.4% of GDP.

TOBACCO TAXATION STRUCTURE IN PERU

In Peru, the cigarette taxation framework is straightforward and consists of three kinds of taxes: General Sales Tax (IGV), the Special Consumption Tax (ISC) and customs duties.¹ Since Peru is an importer of the cigarettes that it consumes (it does not produce or export) and has signed free trade agreements with the exporting countries,² customs duties do not apply as a tax policy instrument.³ Therefore, the simplest and most effective instrument for anti-smoking tax policy is the Special Consumption Tax on cigarettes.

Of the tax structure that affects cigarettes' imports, which is the only source of tobacco supply in Peru, the ISC is the most powerful tool to impact prices due to its flexibility and simplicity to change them. From the early 1990's to the present, most of the available tools for the development of cigarette tax policies (COLAT, 2014), and in particular the ISC, have been used. Since January 2010, a consistent tax policy has been developed, with a fixed-amount ISC regardless of the product. With the latest changes, the average tax burden on cigarette consumption is 60% of the

1> In general, the tax base for the application of IGV on imports is the customs value plus customs duties (specific and *ad-valorem*), plus the tariff surcharge and the Special Consumption Tax (ISC).

2> 98% of imports come from Chile, Colombia and Ecuador, countries with which Peru has free trade agreements. The tax on imports is currently 6% of the "customs value" for all cases in which there is no prior agreement.

3> At present, the General Sales Tax (IGV) is 18%, and its tax base for calculation is the "customs value" plus customs duties and other taxes (with the exception of the General Sales Tax). The "customs value" is made up of the value of the goods, freight, insurance and the corresponding adjustments; and will be determined in accordance with the procedures and methods of the WTO Valuation Agreement.

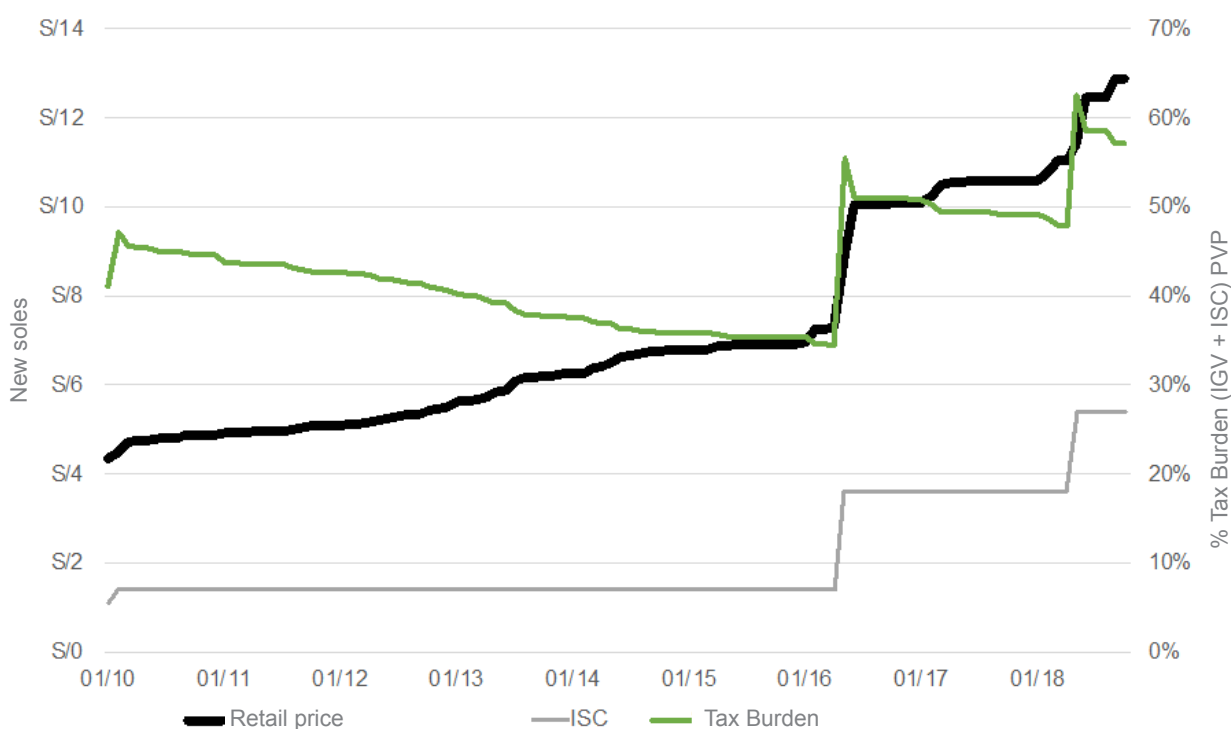
retail price, with 75% accounted for by the ISC, and 25% by VAT (computed over the Hamilton brand).

Since January 2010, the Finance Ministry has been implementing a tax policy for tobacco control based on the introduction of fixed-amount ISC, regardless of product class. The changes in the Government’s tax policy have led to a significant reduction in apparent cigarette consumption, while reducing smoking-related social and economic costs in Peru. However, it has been observed that while the Government does not increase taxes, the tax burden is gradually decreasing because the industry raises the price of its products every year.

However, the increase in the price of cigarettes has been below increases in income, which have been increasing steadily in recent years.

Only after almost six years without any changes in the tobacco tax policy did the Government increase the ISC by 157% (May 2016), which helped to significantly recover the tax burden. This was a turning point in cigarette purchasing power, which was reduced by 38%. Similarly, the changes made in May 2018 helped to further recover the tax burden, which currently stands at 60% (computed over the Hamilton brand), the highest recorded for cigarettes in Peru.

Figure 1: Evolution of the tax burden



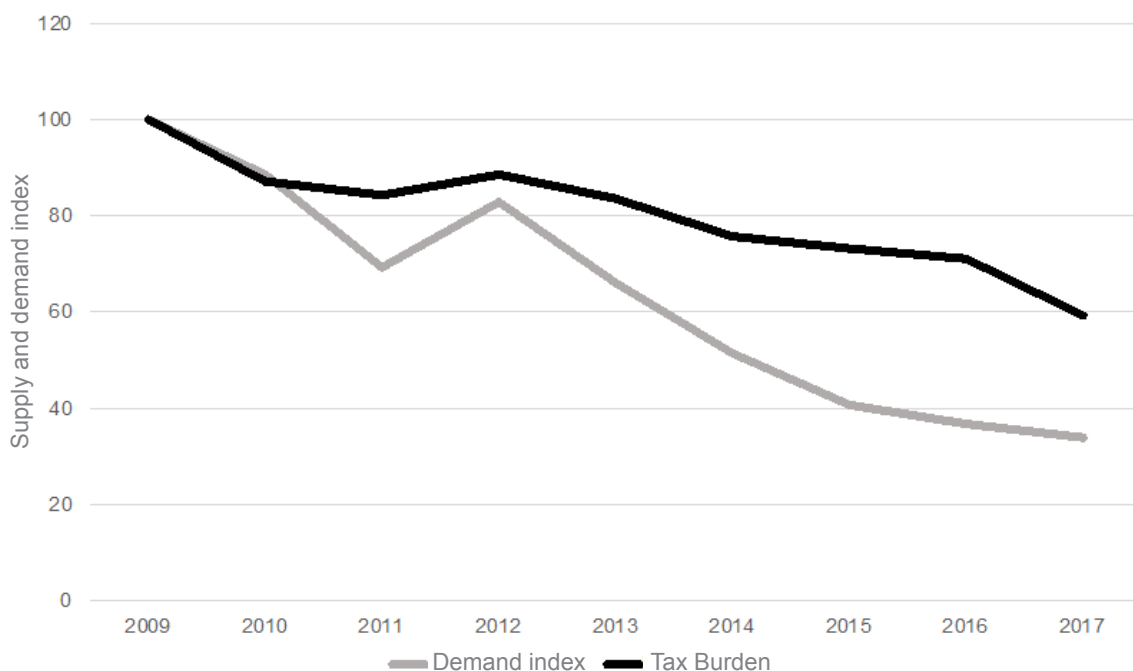
Source: Own elaboration with the Retail Price (PVP) based on Euromonitor; the ISC based on public information and the Tax Charge as an estimate of PVP.

RESEARCH FINDINGS

The findings of the study suggest that the effect of non-tax policies (such as the implementation of the FCTC) is significant and negative on the demand for tobacco, and it is possible to differentiate this effect

from that occurring as a result of price increases. In general, the study confirms the findings of COLAT (2014) regarding the inflexibility of the demand for tobacco, so tax policy instruments could be used effectively to reduce its consumption. In fact, after the latest tax increases, there has been a significant reduction in cigarette consumption.

Figure 2: Evolution of the cigarette supply and demand index per year



Source: Own elaboration with the Supply and demand index based on the National Household Survey (2009 – 2017) and Euromonitor Offer Index.

Figure 2 shows the annual evolution of the demand for cigarettes (consumption) and its legal supply (apparent legally reported consumption). Following the implementation of tobacco control policies and the change in the tax strategy (2010), demand fell (-66%) at a faster rate than formal supply (-41%).⁴ These findings present evidence at odds with the arguments of tobacco importers who claim that tax hikes do not significantly affect consumption but rather encourage

illicit consumption, which affects tax revenues. These trends indicate that the formal market is “stealing” from the informal market and consumption has been falling sharply since 2010. According to the IEP simulations, the long-term elasticity of apparent consumption of cigarettes with respect to the actual retail price is -0.398. This means that a 10% increase in the actual price of cigarettes reduces total cigarette consumption by 3.98% in the long term.

4> For a more in-depth analysis of the impacts of tax increases after the 157% ISC increase in May 2016, a longer-term time series showing trends in both time series is required.

5> Estimated income elasticity is not statistically significant and it is estimated that the evolution of the exchange rate is proportional to inflation, so the only thing that will determine apparent consumption over time is price changes.

6> An overshifting policy involves transferring to the prices a higher increase than the effect of changes in costs. Consequently, a 15% overshift involves increasing prices 15% more than they would have increased by transferring only the increase in costs due to the tax increase.

POLICY RECOMMENDATIONS

In order to identify a sustainable policy for regular increases in taxation, the IEP study developed a predetermined mechanism for constant ISC increase above inflation, which would help to reduce apparent consumption and reach the goal of 70% total tax burden (WHO, 2010) by 2030. Using the estimated demand equation (and the extreme values of the 95% confidence interval) and excluding income elasticity and the exchange rate,⁵ 5% increases in the Special Consumption Tax were simulated for the period 2019-2030, taking account of three possible tobacco industry response scenarios (full transfer of the tax to consumers, 15% overshifting,⁶ adjusting prices in such a way that gross income remains unchanged).

The outcomes of the simulation for 2030 show that a conservative strategy of steady tax increases (5% per year) with a target of at least 70% and an industry reacting as it has been reacting over the past few years – that is, increasing prices by 15% more than the tax increase (overshifting) – would manage to exceed the tax burden objectives. In addition, regardless of the value of the elasticities – ranging between -0.241 and -0.5544 in the simulation – it is observed that major reductions in apparent consumption and significant increases in tax revenue are possible.

In contrast, a more aggressive tax increase strategy (increasing ISC by 10% annually), under the most common strategy followed by tobacco companies in recent years (15% overshifting), would lead to an 82.3% tax burden and reduce affordability by 36.2%. It would also result in a 26.6% reduction in consumption on average. The reduction in consumption would be offset by a 110.7% increase in retail prices, which would increase revenues by 110.1%. Similarly, a sustainable policy of 10% annual increases in the ISC in Peru will have future impacts on a reduction in tobacco-related mortality and morbidity, lower healthcare costs and, above all, a better quality of life.

This study recommends reaching the 70% tax burden suggested by the WHO by 2030 as a tax policy objective. This would consolidate the advances in reducing consumption and the high social and economic costs related to smoking in Peru, in keeping with the literature which points to tax policy as the most cost-effective way to reduce consumption (World Bank, 1999, WHO, 2010).

It is also evident that there needs to be a clear government update programme to keep up with inflation and income increases in the economy in order to prevent the loss of tax burden due to a failure to modify the tax, mainly due to the tobacco industry's policy of regular price increases. This aspect limits the long-term effectiveness of recent tax policies and jeopardizes the objective of increasing the total tax burden to 70% of the retail price.

The simulation results obtained indicate that the tax burden as of 2030 would be between 67.10% and 74.80%, achieving a drop in apparent consumption of between -7.2% and -22.30%, and an increase in revenue of between 34.80% and 56.30%. In this regard, the increase in taxes should be approximately two percentage points above average inflation in the last decade (3%) so as to reach a tax burden that will account for an estimated 70% of the retail price by 2030. In order to achieve this goal, it is proposed that the law should be amended in order to update the ISC on tobacco to 5% annually. This will make it possible to achieve significant reductions in apparent consumption and major increases in tax revenue.

While by their nature tobacco companies will oppose the tax policy, because the increases would be periodic and at a lower percentage than those introduced in 2016 and 2018, there will be fewer arguments to claim that there will be profound changes in demand (for instance, because of increased consumption of illegal cigarettes). In addition, because of the price increases, the sales amounts would increase significantly in real terms, so arguments of an economic nature could not be put forward.

In short, a tax increase that will contribute to reducing consumption is the only strategy that can be repeated over time and constitutes a true long-term (and sustainable) policy measure for tobacco control in Peru, if properly designed.



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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, Ariel Melamud and Patricia Rizzi	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

