Hamburgisches
WeltWirtschafts
Institut

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Tax sovereignty and feasibility of international regulations for tobacco tax policies

Michael Bräuninger

Tax sovereignty vs. international regulations for tobacco tax policies

- Our research determines the parameters of optimal taxation of tobacco products by:
  - evaluating the economic considerations of International coordination and/or Harmonization of tobacco tax policy and Earmarking
  - assessing the negotiations of FCTC Article 6 during the INBs and recent developments in drafting the Article 6 guidelines at CoP 5
- We conclude with recommendation on the draft guidelines

Agenda

- Tax Sovereignty Versus International Coordination and/or Harmonization
  - Economic considerations
  - Treatment of Tax Sovereignty in the FCTC and COP
- Earmarking
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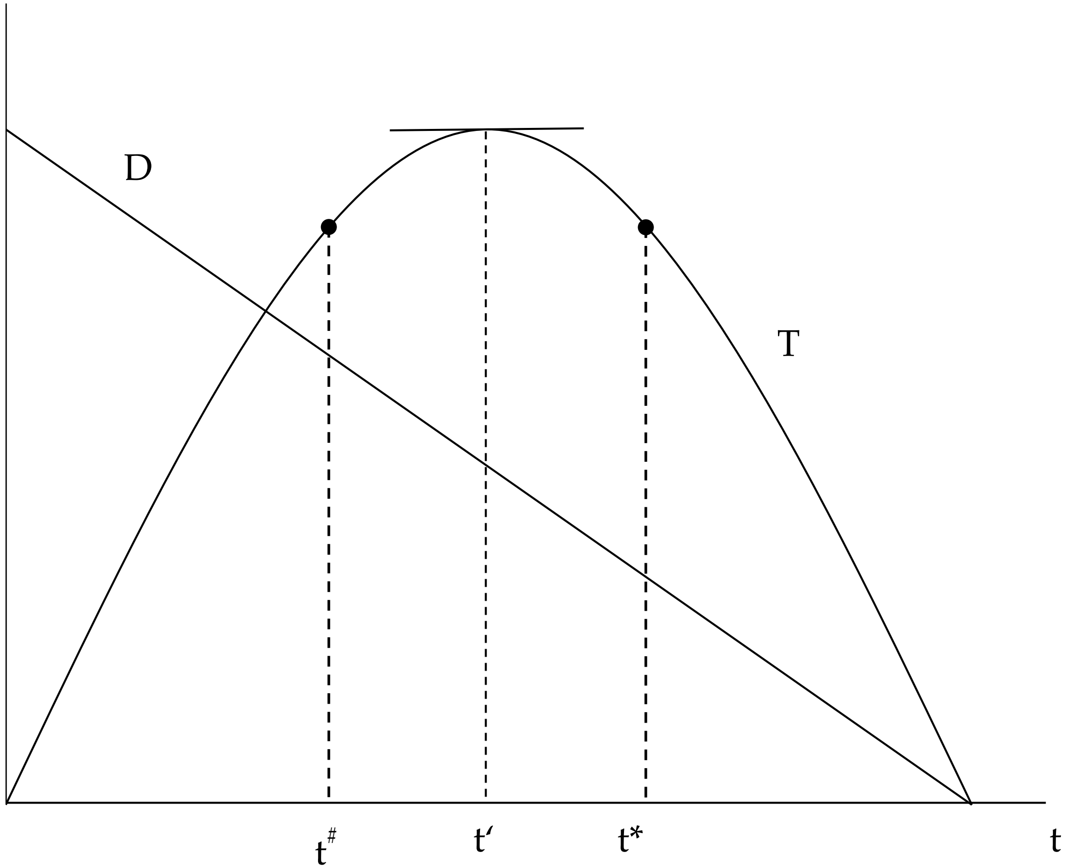
Optimal Tobacco Taxation: Targets and Principles

- General agreement about objectives justifying special taxation of tobacco products
  - raising tax revenues
  - protecting public health
- Tax sovereignty implies
  - ability to raise revenue - i.e. the right to determine tax rates and structures
  - full control of fiscal policy - i.e. determine the use of tax revenues

Optimal taxation



t excise
T tax revenue
D demand
t* optimal excise, with respect to externalities
t‘ revenue maximizing excise
t# optimal excise, taking account of consumers’ preferences

Three scenarios:

1. Optimal excise to **maximize revenue**: t’
2. Optimal excise to **reduce negative externalities**: t* (can be undermined by substitution from taxed to untaxed consumption)
3. Optimal excise **considering consumers’ preference**: t#

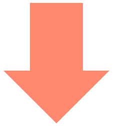
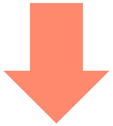
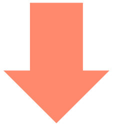
A simple model of optimal tobacco taxation

- Government maximizes median voters' welfare depending on tax revenues, externalities, income, price level and awareness of health risks
- Optimal tax defined as:

$$t^* = \frac{(1+2\alpha(e-s))(A-\alpha c)}{2\alpha(1+\alpha(e-s))}$$

- Where:
  - A is a function of income and awareness of health risks
  - α determines the price sensitivity of demand
  - e measures the weight of the externality
  - s quantifies the welfare of smokers derived from using tobacco products

A simple model of optimal tobacco taxation: Effects of parameter changes

Parameter change	Optimal Tax Level
▪ Increase in income	
▪ Better public awareness of health risks	
▪ Enlarged illicit supply of tobacco, which increases price sensitivity	
▪ Stronger smoking regulations, which reduce the externality	

Optimal tobacco taxes: Main findings

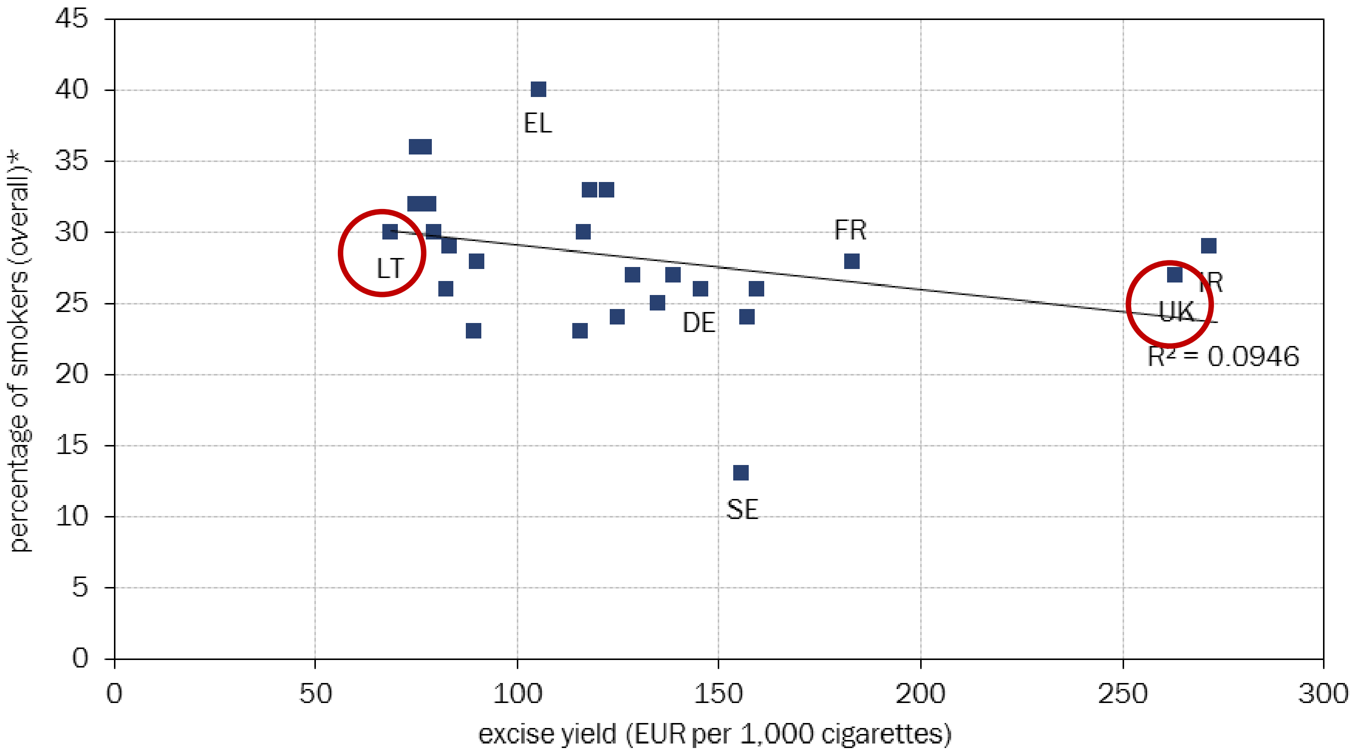
- The optimal level of taxation differs across countries depending on country-specific parameters such as:
  - Income
  - Regulations
  - Culture
  - Education/Risk awareness
  - Illicit tobacco consumption

Even EU has not achieved a full tax harmonization

- Even in the EU – a single market with free movement of goods and services, substantial differences in tobacco tax levels exist between the member states:
  - excise tax on cigarettes varies between €72 per 1000 cigarettes in Lithuania and €288 in the UK - i.e. almost four times the difference
  - this is mainly driven by significant divergence in incomes
- There is no <u>a single optimal tax level even in the EU</u>

Tobacco tax rates and smoking prevalence

- Lithuania and UK at the lowest and highest end of excise yield range both have similar smoking prevalence: 30 % and 27 %



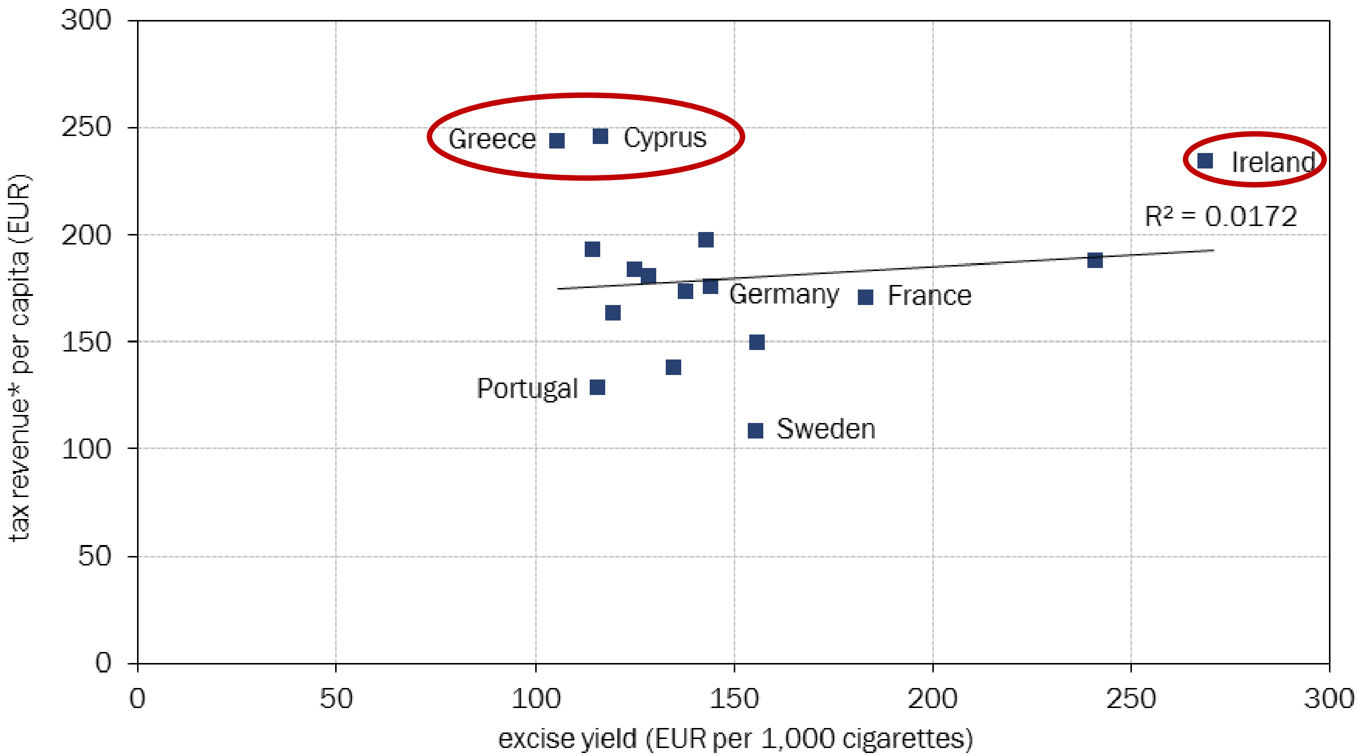
* 2011 and before

Quellen: European Commission (2012a, 2012b); HWWI.

- No correlation between excise tax level and proportion of smoking population

Tobacco tax rates and Tax Revenues

- Greece and Cyprus have relatively low excise yields but high tax revenues per capita
- Ireland has very high excise yields and high tax revenue per capita



- No correlation between excise yields and tax revenues

* Revenues from taxes on consumption (excise duties and similar charges) other than VAT.

Quellen: European Commission (2013); Eurostat 2014; HWWI.

Summary: No single optimal tax level for all countries

- Significant country differences mean optimal tax levels can vary vastly
- International coordination and/or harmonization of tax rates does not make economic sense and may have negative effects due to countries' vulnerability to illicit tobacco trade
- Analysis of the EU shows there is no correlation between excise yields and smoking prevalence as well as tax revenues

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Fiscal Sovereignty is fully respected and FCTC Article 6 does not contain prescriptive language and/or obligations

Article 6

Price and tax measures to reduce the demand for tobacco

1. The Parties recognize that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons

2. **Without prejudice to the sovereign right of the Parties to determine and establish their taxation policies**, each Party should take account of its national health objectives concerning tobacco control and adopt or maintain, **as appropriate**, measures which **may** include:

   a) implementing tax policies and, **where appropriate**, price policies, on tobacco products so as to contribute to the health objectives aimed at reducing tobacco consumption; and

   b) prohibiting or restricting, **as appropriate**, sales to and/or importations by international travellers of tax- and duty-free tobacco products

EU places high importance on tax sovereignty of individual Member States

- Decision-making on taxation requires <u>unanimity</u> of all 28 Member States (applied only to tax, defense and foreign policy)

"One of the ***key components of a state's expression of sovereignty is the right to determine the level of expenditure and the tax rates and structures required to support it****. . . .* ***This is a basic part of the democratic process****. . . .* ***By having unanimity in taxation matters, we can reach decisions which reflect the concerns and core interests of every member state.****"*

Irish Minister of Finance

"We have been very clear – nothing on tax. ***Tax is the province of the national states. Anything to do with tax is about sovereignty****, and the* ***Treasury must have control over how and what is collected****."*

The British Government

*"****Sovereignty and tax are very linked****. […]* ***parliamentary control on taxes is very deeply rooted in people's minds****."*

The Chair of the European Joint Transfer Pricing Forum, speaking from the French perspective

INB sessions: Negotiations of FCTC Article 6

- Parties <u>unanimously</u> agreed that tax laws should <u>not</u> be subject to regulation by international agreements
- Prescriptive obligations seen as inappropriate and unacceptable because national tax regulations would not permit outside body or treaty to create obligations in this important area

INB sessions: Parties’ statements

*“The text should also ensure that the **provisions on taxation did not indicate or imply any limitation of sovereignty over taxation policy**.”*

(EU at INB 5/2002)

*“**Under its Constitution, the United States Government could not cede tax policy to any international body.**”*

(USA, INB 2/2001)

*In regard to Article 6, taxation policy was a critical part of any national agenda. Since the factors underlying tax policy decisions were left to each individual Party it was **inappropriate for the convention to dictate a uniform objective for national tax policies**.*

(Japan, INB 5/2002)

*India agreed with speakers who maintained that **tax laws were a sovereign right of nations and were not subject to regulation by international agreements**, but only by national authorities.*

(India, INB 2/2001)

CoP 5: Development of Article 6 guidelines

- Chapter 3.2 “Level of tax rates to apply” recognizes upfront:

> *“As recognized in Guiding Principle 1.1, Parties have the sovereign right to determine and establish their taxation policies, including the level of tax rates to apply.* ***There is no single optimal level of tobacco taxes that applies to all countries because of differences in tax systems, in geographical and economic circumstances, and in national public health and fiscal objectives****”*

- However, this is followed by prescribing a single rate of 70% of retail selling price (WHO recommendation) – **i.e. apparent contradiction**

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Earmarking: Theoretical consideration

- Welfare maximizing government: tax and public spending are always optimal - i.e. no rationale for earmarking
- Buchanan (1963): Possible case for earmarking when political decision-making process is explicitly taken into account
- More realistic models show that earmarking likely leads to non-optimal solutions as:
  - Earmarking impedes quick adjustment to changes in costs or demand
  - Earmarking requires supplementary aid to adjust for dynamic changes in tax revenue or production cost of the public good

Earmarking: Empirical evidence is stable over time

IMF Working Paper, Allen and Radev (1996):

*"**[earmarking deprives] elected officials of the freedom to allocate funds among competing expenditure programs in accordance with currently perceived needs.**"*

van Walbeek et al. (2013):

*"**Even though some countries earmark a portion of their tobacco tax revenue for tobacco control, or for public health in general, we know very little about the success or failure of such efforts**, and to what role earmarking can play in reducing the impact of higher tobacco taxes on the poor."*

Oxford Economics (2013):

*Earmarking **encourages rent-seeking behavior**: earmarking provides an incentive for interest groups to lobby for increases in the earmarked taxes. As a result, the interest group benefits from the receipts and others have to pay.*

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INB sessions: earmarking is rejected from inclusion into Article 6

- Earmarking of tax revenues for tobacco control was clearly rejected during INB sessions due to:
  - incompatibility with national constitutions and tax laws
  - undermining of national tax sovereignty

CoP 5: Parties adopted the recommendation on earmarking under high pressure

- Non-binding character of the guidelines and several safeguards in the text were used as justification to adopt it:

*"**China's legal system would not allow for the earmarking of tax revenues.**"*
(China at CoP 5 2012)

*"[The Committee Chair] understood the concern expressed by the representative of China, but asked him to remember that it was just a recommendation, not a guideline; **that the word 'earmarking' was not mentioned;** that taxation revenue was cited only as an example; **and that there were several safeguards in the text, such as the word 'could'** in the phrase '**the Parties could consider …** dedicating revenue **…** to tobacco-control programmes', and the words '**in accordance with national law.**'"*

(Committee Chair answering to Parties' comments on earmarking)

CoP 5: despite opposition of multiple parties, earmarking was included as a compromise

““The chapter on use of revenues financing of tobacco control, which concerned the ***thorny issue of earmarking,*** *had been* ***included as a compromise.****”*

(Conference of the Parties to the WHO Framework Convention on Tobacco Control 2012)

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- Parties have to reject Article 6 guidelines as they currently stand when debated at CoP 6 in Moscow on 13-18 October 2014 as they:
  - undermine nations' tax sovereignty
  - contradict the Treaty provisions and intentions of Parties
  - do not make any economic sense