

**EXCISE DUTY AS A MEANS OF REGULATING CONSUMER  
BEHAVIOUR IN KENYA;  
A CASE OF THE TOBACCO INDUSTRY**

**BY:-**

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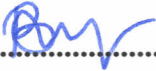
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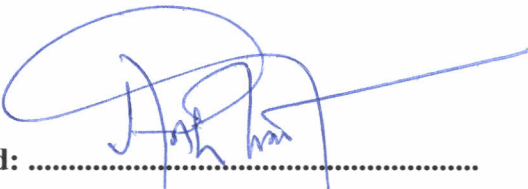
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## **DEDICATION**

To my loving Family,

Ches, for the unsurpassed love and encouragement,

Andrew and Alvin, for the joy of being your mother.

## **ACKNOWLEDGEMENTS**

I wish to thank Professor Eshiwani, my supervisor, for the time, guidance and support given,

My parents, in-laws and siblings for encouraging and supporting me,

To Ches, for rallying me on everyday and being a witness to my journey,

To God, for grace and favour and making it possible.

## TABLE OF CASES

1. COMMISSIONER OF INLAND REVENUE THE DUKE OF WESTMINSTER  
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3. SCOTT V RUSSELL (INSPECTOR OF TAXES) TC 394

## ABSTRACT

Excise tax is a levy applied selectively on particular goods and services. It has been used world over for two major reasons; as a means of raising government revenue and to regulate consumer behaviour. The major argument when addressing consumer behaviour is that an increase in the price of any commodity is bound to influence the will and capacity of consumers to spend on the commodity.

This thesis contends that variation in price will not necessarily affect all consumers. When considering the case of tobacco consumption, the impact of an increase in excise tax will be felt most by the poor and underage consumers. Excise tax would therefore be a useful tool in regulating tobacco consumption in developing countries and also discouraging teenagers from starting the habit. The consumption of tobacco is a major issue worldwide because tobacco is a leading cause of death and also imposes a high burden on society by virtue of the high medical bills involved in treating patients.

The thesis therefore proposes that excise tax should be increased regularly with the aim of discouraging new smokers from taking up the habit and also reducing the number of smokers amongst society's poor.

Key words; excise tax, consumer behaviour, revenue collection and teenage consumption.



# **CHAPTER ONE**

## **1.0 SETTING THE AGENDA FOR THE STUDY**

### **1.1 Background of the Study**

The primary aim of taxation is to raise revenue for government expenditure and to enable government meet its fiscal requirements. The government spends part of the money on services which private enterprise cannot provide like defence, law and order. It also pays for services that are provided on a universal basis like social security benefits and education. Another purpose is the redistribution of wealth and income. It is generally agreed that income tax should be “progressive”, and that some government revenue should be spent on welfare services.

Another purpose is control of the economy. Changes in taxation can and do affect the economy, but control is exercised by adjusting the money supply and credit. Taxes may also be used as a form of social control. They influence consumer behaviour particularly by changing relative prices and making certain products more and more expensive and thus reducing affordability. This therefore reduces consumption by the masses. Taxes are also used to make sure that people pay the full price for goods and/or services; this is the main reason behind pollution tax.

Historically, governments have raised revenue from a mixture of direct and indirect taxes. Direct taxes are levied on income, profits and property, while indirect taxes are taxes on the consumption of a range of goods and services.<sup>1</sup> Governments however, tend to increase their reliance on indirect taxation as economies mature because indirect taxes are more difficult to evade than income tax. They are also a more predictable revenue earner because at the economy-wide level consumption fluctuates less than income does.

Most countries apply excise taxes to certain classes of goods like petrol, alcohol, tobacco, motor vehicles, coffee and perfumes<sup>2</sup>. Historically, such products were considered luxury items because those who consumed them tended to have higher incomes and could afford to pay more; hence they were easier tax targets.

Tobacco products raise huge amounts of revenue for government and yet they are controversial politically and socially. One major issue is the adverse health issues that arise as a result of tobacco consumption. The World Health Organisation (WHO) through the Framework Convention on Tobacco Control (FCTC) has come up with guidelines on how tobacco should be taxed.<sup>3</sup>

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<sup>1</sup> Excise tax is a form of indirect tax.

<sup>2</sup> The Budget Speech read by Hon Uhuru Kenyatta for the Financial Year 2008/2009 does not however reflect a trend established in past budget speeches of increasing excise duty on tobacco products.

<sup>3</sup> The Framework came into effect on 27<sup>th</sup> February 2005 and was negotiated by 192 WHO member States. It was unanimously adopted by the 56<sup>th</sup> World Health Assembly in May 2003. Kenya is a signatory.

Both the WHO and World Bank have argued in support of governments raising excise tax to reduce tobacco consumption. The Framework obliges parties to the treaty to take into account national health objectives that relate to tobacco control when determining their tax policies. It also requires parties to implement tax policies and where appropriate, pricing policies aimed at reducing tobacco consumption.<sup>4</sup> The FCTC also provides that, “Parties shall provide rates of taxation for tobacco products and trends in tobacco consumption in their periodic reports to the Conference of the Parties.”<sup>5</sup>

The key points made by the two organizations are that firstly, tax-induced price-rises on tobacco products are among the most effective interventions in reducing demand, especially among youth and persons with low income. A second reason is that the World Bank believes that imposing long-term high taxes on tobacco products reduces teen use and will have a lasting impact on consumption. At the same time, tobacco taxes are an efficient means of raising government revenue.

A Report<sup>6</sup> by the World Bank seeks to provide an economic justification for increased intervention in the tobacco market. The basis for intervention relies on four main arguments. First, smokers especially the young and poorly-educated are not aware of the risks associated with smoking. Second, smoking imposes greater costs on those in lower socio-economic groups than those in higher socio-economic groups and that the former are not able to make

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<sup>4</sup> Article 6 of the FCTC Price and tax measures to reduce demand for tobacco.

<sup>5</sup> Article 21

<sup>6</sup> The World Bank (1999) *Curbing the Epidemic: Governments and the Economics of Tobacco Control*. Washington DC : The World Bank

rational decisions about whether they should smoke. Third, smoking imposes external costs on others and lastly, that far from imposing economic costs and endangering jobs, tobacco control will actually result in increased employment opportunities in many countries.

This paper analyzes the structure of excise taxation in Kenya and investigates the extent to which the taxes have met their commonly stated objectives - that is, to raise substantial revenue for Government, to discourage consumption of certain potentially harmful products and to promote equity.

## **1.2 Statement of the Problem**

The aim of this study is to establish whether excise tax is an effective tool in regulating consumer behaviour especially with regard to products considered harmful to the individual and society. An example of such a product is tobacco which is considered a leading cause of death especially in developing countries.

The major aspects to be looked into in carrying out this study include establishing whether the government enforces excise tax because it has a keen interest in increasing its revenue earnings or indeed it wants to regulate the behaviour of its citizens. The main question is whether the government's interest in earning revenue overrides its health concerns for its citizens. This study will therefore establish whether the government in imposing excise tax

does so to meet its revenue targets or to control the negative externalities which arise out of certain habits like smoking.

A second aspect to be addressed is whether excise tax is more revenue generative than any other tax. It is also important to consider whether tax payers are aware of the excise tax and what impact if any the tax has on their behaviour. It is also important to consider what other avenues are available for controlling tobacco consumption and whether excise tax is the best avenue.

The study will therefore seek to address these issues by establishing what excise tax is, why governments impose excise taxes, the impact of excise tax on behaviour and whether it is a deterrent for smokers and lastly a comparative analysis of the law pertaining to excise tax in Kenya and other jurisdictions.

If consumption of these products is fairly insensitive to changes in relative price, the more significant impact of imposing high taxes on them will be a reduction of real income for those who consume them in spite of the higher price, rather than a reduction in consumption.<sup>7</sup> This is because individual's react to price increases by reallocating the limited resources.

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<sup>7</sup> Okello , "An Analysis of Excise Taxation in Kenya, African Economic Policy" Discussion Paper Number 73, June 2001, Equity and Growth through Economic Research (EAGER)

### **1.3 Significance of the Study**

The study will delve into the importance of excise tax in regulating consumer behaviour and whether it is punitive and should thus be reduced or it is effective and should thus be enhanced. The paper seeks therefore to provide useful guidance for government policy makers, health officials and social workers who are keen on reducing the number of smokers and those affected by smoking.

### **1.4 Conceptual/ Theoretical Framework**

The word 'excise' is derived from a dutch word, '*accijns*', which is itself presumed to originate from the latin word '*accensare*' which means "to tax"<sup>8</sup>.

Excise tax has been defined as "a tax levied on certain goods and commodities produced or sold within a country and on licenses granted for certain activities"<sup>9</sup> but no explanation is provided as to what the word "certain" stands for.

The definition of excise tax is however vague and it is difficult to find a precise definition explaining what it is that categorizes goods subject to excise tax. Statutes in many countries provide a list of goods which are eligible to excise tax without giving a precise definition of what excise tax is. It is only possible to hazard a guess as to the motives which were used to group such goods together.

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<sup>8</sup> The Oxford English Dictionary

<sup>9</sup> The New Oxford English Dictionary, Revised Second Edition, 2005

In Kenya, excisable goods are defined as “goods manufactured in Kenya or imported into Kenya on which an excise duty is imposed under this Act;”<sup>10</sup>

The same situation prevails in England, where the following items, activities and general areas are listed as being subject to excise duty: "alcohol, environmental taxes, gambling, holdings & movements, hydrocarbon oil, money laundering, refunds of duty, revenue trader's records, tobacco duty, and visiting forces".<sup>11</sup> It does not however, provide any further explanation as to what links these items.

Based on the foregoing, excise tax can be defined as a levy applied selectively on particular goods and services. Such levies are applied for a variety of reasons, the main one being their ability to raise substantial revenue for government at relatively low administrative or compliance costs.

The study will be based on the utilitarianism theory which was espoused by Jeremy Bentham (1748-1832) and John Stuart Mill(1806-1873). The concept basically holds that an action is judged as right or wrong depending on its consequences. The ends of an action justify the means taken to reach those ends. As a consequentialist principle, the moral authority that drives utilitarianism is the calculated consequences of an action, regardless of other principles that determine the means or motivations for taking the action.

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<sup>10</sup> - Customs and Excise Act, Cap 472 (1st Booklet)

<sup>11</sup>Acquiring Goods within the EU: Excise Goods and Excise Duty  
<<http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1078164770>>, accessed on 17<sup>th</sup> May 2009

It also includes the following tenets:

1. An action is morally right if it produces the greatest good for the greatest number of people affected by it.
2. An action is morally right if the net benefits over costs are greatest for all affected, as compared to the net benefits of all other possible choices considered.
3. An action is morally right if its immediate and future direct and indirect benefits are greatest for each individual, and if these benefits outweigh the costs of those considered for other alternatives.<sup>12</sup>

Utilitarianism is a useful principle under the following circumstances: when resources are lacking or scarce, when priorities are in conflict, when there is no clear choice of fulfilling everyone's needs and goals, and when large or diverse collectives and groups are involved in a situation where there is a fixed and limited number of resources to be distributed.

The "benefits" of an action may include any desirable goods like pleasures, health, lives, satisfactions, knowledge, happiness produced by an action while "costs" may include any of its undesirable evils like pain, sickness, deaths, dissatisfaction, ignorance or unhappiness.<sup>13</sup>

The term used to refer to the net benefits of any sort produced by an action is "utility" hence the name utilitarianism for any theory that advocates selection of that action or policy that maximizes benefits (or minimizes costs).<sup>14</sup>

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<sup>12</sup> Weiss J.W.(1994) *Business Ethics: A Managerial Stakeholder Approach*, (Biedmont CA:Wadsworth Publishing Co. Ltd.), p66

<sup>13</sup> Vekeza Ethics,(1992) *Concepts and Cases*, (Prentice Hall: London,), p60

<sup>14</sup> *ibid*



Utilitarianism states that if the harm done to society by any practice is sufficiently serious, then legislation should be passed subjecting the action to legal as well as moral sanctions. To be effective the sanctions must outweigh the good that the perpetrator of the action hopes to gain. Excise taxes seek to regulate behaviours which are considered a luxury and unnecessary. In the case of tobacco and alcohol taxation, excise tax acts as a deterrent to those who wish to engage in behaviour society considers unhealthy.

Tobacco smoking when looked at from a utilitarian perspective with regard to its consequences to the individual and society in general is considered morally wrong. This is because of the harmful effects tobacco and alcohol pose to the user and in the case of tobacco, this includes harm to third parties. Another consequence of tobacco smoking is the cost in medical expenses which the society has to bear to treat individuals who develop health problems related to tobacco consumption.

Excise taxes are mainly levied at relatively high rates on a few commodities, which are produced by a few large producers. The main characteristic of such commodities is that they tend to have a low own-price elasticity of demand. This implies that there is minimum shifting of consumer purchases when prices change and thus very high tax rates can be applied. This coupled with strict administrative controls by tax authorities normally results in substantial tax revenue.

The other reason for the imposition of these selective taxes is to correct negative externalities<sup>15</sup> arising from the consumption of the taxed products. The consumption of certain products, e.g. smoking cigarettes or excessive drinking of beer and other alcoholic beverages, is harmful not only to the individual consuming the product but also to society at large, both in the short-run and in the long-run. In such cases, market forces produce distorted prices, which exclude the cost to society of consuming these commodities and hence result in higher consumption. The outcomes produced by the market forces then need to be corrected for these negative externalities. The relatively high taxes imposed on these products are, therefore, meant to ensure that individuals internalize the cost to society of their consuming these products.

Finally, excise taxes are applied to improve the vertical equity of the tax system. Levying them on commodities that can be described as being luxuries that are consumed in higher proportions by higher-income individuals normally does this. Excise taxes are also used to promote equity by spending the collected revenue on employment-generating and poverty alleviation programmes, which benefit low-income groups.

On the other hand, Belch and Belch define **consumer behaviour** as 'the process and activities people engage in when searching for, selecting, purchasing, using, evaluating, and disposing of products and services so as to satisfy their needs and desires'.<sup>16</sup>

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<sup>15</sup> An externality is an activity of one entity that affects the welfare of another entity in a way that is outside the market mechanism

<sup>16</sup> Categories: Consumer behaviour, <[http://en.wikipedia.org/wiki/Consumer\\_behaviour](http://en.wikipedia.org/wiki/Consumer_behaviour)>, accessed on 6th of June 2009

Consumer behaviour involves the psychological processes that consumers go through in recognizing needs, finding ways to solve these needs, making purchase decisions (e.g., whether or not to purchase a product and, if so, which brand and where), interpret information, make plans, and implement these plans (e.g., by engaging in comparison shopping or actually purchasing a product).

Consumer behaviour (in consumer business context) has also been referred to as the study of when, why, how, where and what people do or do not buy products.<sup>17</sup> It blends elements from psychology, sociology, social psychology, anthropology and economics. It attempts to understand the buyer decision making process, both individually and in groups. It studies characteristics of individual consumers such as demographics and behavioural variables in an attempt to understand people's wants. It also tries to assess influences on the consumer from groups such as family, friends, reference groups, and society in general.

The concept of regulation on the other hand refers to “the creation of formal standards and codes of conduct which private individuals and firms must follow. These standards are rules that mandate certain behaviour and they are normally created and enforced by government.”<sup>18</sup>

Regulatory standards which are imposed by government and backed by the enforcement authority of the state set boundaries and limit individual and commercial freedom, to change standards of behaviour and to enforce economic order which is in line with the overriding aim of regulation.

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<sup>17</sup> *ibid*

<sup>18</sup> Davies H. (1998) “*Why Regulate?*” the Henry Thornton Lecture,( City University Business School), p3

The function of regulation refers to the mandatory enforcement of standards of behaviour that reflect wider public policy interest worthy of promotion at the expense of unlimited freedom. The concept of regulation generally aims to “shield the market against anticompetitive practices, to guarantee the provision of certain public goods such as electricity, communication and transportation, to promote workers’ and consumers’ health and safety, to advance environmental protection ...”<sup>19</sup>

## **1.5 Research Methodology**

The main mode of research shall be secondary with the main source being library based. Recourse will be made to relevant statutes, books, international treaties, conventions and the internet. The research will delve into the law which has emerged in different jurisdictions. Time allowing, the researcher will interview individuals working in the Kenya Revenue Authority and members of the public for insight into the impact of price increments on tobacco on their behaviours.

The choice of secondary sources to collect data is informed by the limited amount of time available for carrying out the study.

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<sup>19</sup> *ibid*, p4

A major limitation of the study is the fact that little research has been carried out into taxation in developing countries. Though information is available on the internet, its relevance and accuracy may not be assured.

### **1.5.1 Objectives of the Research**

The objectives of this study are;

- a) to establish the national and international legal framework pertaining to excise taxation.
- b) to examine the impact of excise tax on taxation of tobacco products and hence its effectiveness as a tool for regulating behaviour.
- c) to identify legal and institutional reforms needed to ensure greater efficiency and utility of excise tax to regulate consumer behaviour

### **1.5.2 Hypotheses**

The main hypothesis for this study is that governments impose excise tax with the main aim of raising revenue and that the regulation of behaviour is an added advantage. Another hypothesis to be established is that excise tax is an important tool in regulating consumer behaviour and thus controlling harmful consumer behaviour for example, the abuse of tobacco. Major legal and institutional reforms are needed to ensure greater efficiency and utility of excise tax in regulating consumer behaviour. Lastly the study will seek to establish that individuals who partake of excisable products are rarely aware of the tax and that the tax is not visible to the taxpayers. Taxpayers respond to the increase in prices and are not aware of the changes in tax.

## **1.6 Profile of the Study**

Chapter One will provide insight on excise tax generally. It will give a statement of the problem, significance of the study, literature review, objectives of the research, hypothesis, assumptions, research questions and research methodology.

Chapter Two will discuss the justifications used by governments levy excise, the relationship between excise tax and consumer behaviour. It will seek to shed light on the common reaction excise duty elicits from consumers and the reasons behind these responses.

Chapter Three will provide a comparative analysis of the different approaches taken in different jurisdictions with regard to excise tax and regulation of consumer behaviour in the tobacco industry. It will also provide a comparative study of the efforts made in other jurisdictions to address the issue of managing consumer behaviour.

Chapter Four will make suggestions on the improvements which can be made to improve on the effectiveness of excise tax as a means of regulating consumer behaviour.

## CHAPTER TWO

### 2.0 EXCISE TAX AND CONSUMER BEHAVIOUR

*"The motive for the implementation of excise should be nothing more than to curb the pursuit of goods and services harmful to our health and morals."<sup>20</sup>*

#### 2.1 Introduction

Excise taxes form a substantial proportion of revenue for governments all over the world, and especially in low-income developing countries. They are levied on a few goods characterised by low price elasticity of demand.<sup>21</sup>

Excise tax on tobacco is considered a sin tax because it is a tax which is meant to discourage behaviour associated with inefficient decision-making on the part of individuals in society.

Samuel Johnson [http://en.wikipedia.org/wiki/Excise\\_tax\\_-\\_cite\\_note-3](http://en.wikipedia.org/wiki/Excise_tax_-_cite_note-3), on the other hand defines excise in his 1755 dictionary as, "*Excise - A hateful tax levied on commodities, and adjudged not by the common judges of property, but wretches hired by those to whom excise is paid.*"<sup>22</sup>

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<sup>20</sup> According to Adam Smith, <<http://en.wikipedia.org/wiki/>> accessed on 10th June 2009

<sup>21</sup> This means that there is minimal cutback in consumption of the good as price increases.

<sup>22</sup> "Samuel Johnson on excise, 1755". <http://www.ctj.org/html/quotes.htm> accessed on 10th June 2009

Almost as long as there has been a tobacco trade, there has been a tobacco tax.<sup>23</sup> Soon after Columbus introduced tobacco to Europe, governments realized the benefit that the weed could yield to their treasuries, and, hence, the tobacco tax was born<sup>24</sup>. Long designed only as a government revenue-maker, the tobacco tax has undergone a dramatic transformation in recent years. As the health risks of smoking became increasingly apparent and the cigarette companies lost their chokehold on political power, excise tax has come to be a tool for public health initiatives. The rise in excise taxes has been met with heated debate.

On the one hand, detractors depict the tax as nothing more than a vast government windfall, generating inefficiency, burdening the poor, and imposing on the individual. Supporters, on the other hand, argue that the increased taxes can save millions of dollars and thousands of lives per year, while improving both individual and social welfare. In light of the ongoing debate on the efficacy of excise tax, this chapter will look at the impact of government excise tax policy on consumer behaviour.

## 2.2 Justification for Excise Taxes

Deducing from the types of goods, services and areas listed as excisable by many governments, a logical conclusion might be that excise tax was originally invented for some or all of the following reasons:

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23 Rosin, H. "The Fat Tax," *The New Republic*. 18 May 2009 (The New Republic Online Archive) Viscusi, W. (1995) "Cigarette Taxation and the Social Consequences of Smoking." *Tax Policy and the Economy* 9: p51-101.  
24 Chaloupka, F., et al (2000) "The Taxation of Tobacco Products." In *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka, (Oxford: Oxford University Press), p237-238.



- a. to protect people from harming their health by abusing substances such as tobacco and alcohol, thus making excise a kind of sumptuary tax,
- b. from harming themselves and others indirectly and morally by engaging in activities such as gambling and prostitution thus making it a type of vice tax or sin tax,
- c. from harming those around them and the general environment from overuse of certain harmful substances and includes curbing activities which contribute to pollution (hence the tax on hydrocarbon oil and of other environmental taxes, as in the UK), or from harming the natural environment (hence the tax on hunting in the UK) thus also making excise a kind of pigovian tax,
- d. to provide monies needed for the extra healthcare and other public expenditures which will be needed as a direct or indirect result of excisable activities, such as lung cancer from smoking or road accidents resulting from drink-driving
- e. for defence including taxation directly levied on other countries' militaries and/or governments, such as the UK's taxation on "visiting forces"
- f. to punish. Many US states impose taxes on drugs, and the UK government imposes excise on money laundering and on "visiting forces" (which can, from a legal standpoint, also be interpreted as "invading forces"). These are included in the statute books not because the government expects smugglers, launderers and invaders to pay for the right to conduct their harmful and illegal activities, but so that greater punishments and reparations/war reparations - based mainly around tax evasion - can be imposed in the case that the perpetrator is caught and tried. Aside from the extra revenue, this of course can also act as a deterrent.

## 2.3 Reasons why Governments impose excise tax

The central purpose of taxation is to raise revenue in “a reasonably non-distorting, equitable, and sustainable manner”<sup>25</sup>. This means that a tax system needs to yield adequate revenue, be efficient and fair. The consensus is that indirect taxes should rest on a broadly based consumption tax, complemented with excises.<sup>26</sup>

### 2.3.1 Revenue Adequacy

*“The most compelling reason for the use of excise taxes is that they can potentially raise a great deal of revenue with little distorting effect.”<sup>27</sup>*

For a tax system to continue to raise adequate revenue, it helps if taxes are income-elastic. This occurs when revenue rises in line with national income even when no adjustments are made to the tax rates or bases. Where the tax system lacks elasticity, taxes will have to be modified frequently to maintain revenues, and “the accumulation of piecemeal changes is likely to create an unwieldy and inefficient system”<sup>28</sup> Excise taxes are an important source of revenue and the rates are easy to change. This makes them a tempting target for short-run efforts to enhance revenue.<sup>29</sup>

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<sup>25</sup> Burgess, R. et al. (1993) Taxation and development. *Journal of economic literature*, June, 7 p2; World Bank 1991 *Lessons of tax reform*. Washington, D.C.

<sup>26</sup> *ibid*

<sup>27</sup> McCarten, W. et al (1995). *Excise taxes* (London, Oxford), p100

<sup>28</sup> Haughton, J. and Soumodip S. (1996) Gasoline tax as a corrective tax: estimates for the United States, 1970–1991. *The energy journal*, 17 (2), p7

<sup>29</sup> *ibid*. When Tanzania reduced its excises in 1992–1993, for example, the revenue cost was so high that an IMF tax mission in 1993 recommended reversing the policy. Another IMF team recommended increases in excise rates for Madagascar to help improve the weak tax effort of that country

### 2.3.2 Efficiency

The retail price of tobacco does not necessarily reflect its social cost. Tobacco related costs, such as increased public healthcare expenditure, and costs associated with environmental tobacco smoke, are not borne by the smoker, but by society.

Good taxes are efficient. There are several dimensions to efficiency. An efficient tax has low administrative costs i.e. it is more than 2 percent of total revenue. Most excises, and particularly the traditional ones, are relatively cheap to apply. An efficient tax has low compliance costs, which are the costs borne by taxpayers as they try to comply with the tax laws. Also, an efficient tax does not unduly distort the choices that producers and consumers make about what to produce and consume, how to produce it, and in what quantities.

When the use of a good or service causes negative externalities<sup>30</sup>, the standard prescription is to levy a Pigovian (corrective) tax, which forces the supplier to internalize the costs of the negative side effects<sup>31</sup>. Alcohol use leads to road accidents, family stresses, and hospital costs. Tobacco use is unpleasant for non-smokers, and increases the demand for publicly supported health care, particularly for treating lung cancer<sup>32</sup>. The use of fossil fuels produces pollution and congestion. The presence of these negative externalities provides a case, in principle at least, for corrective taxes on these traditional excisable items.

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30 Costs imposed on society for which the user does not pay, are called negative externalities.

Where there are negative externalities, an excise tax will increase economic efficiency; an efficient outcome is achieved at that point where the excise-included retail price equals the social cost of the product

<sup>31</sup> Nellor, D. (1995) *Environmental taxes*, (London; Oxford) p25

<sup>32</sup> Supra note 14 p51-101

Taxes on motor fuels and vehicles have a further justification. They represent a form of charge on road users. Ideally, one would like to charge directly for the construction costs and wear and tear on roads, but since this is impractical, using taxes on motor fuel may provide an alternative. The argument is weakened if a significant quantity of petroleum products is used for other activities (such as tractors on a farm); this helps explain why the tax rate on diesel fuel is typically lower than the tax rate on gasoline.

Sumptuary taxes on alcohol and tobacco are sometimes justified on the grounds that they discourage the consumption of goods that morally ought to be discouraged. This is particularly notable in the high taxes on alcoholic beverages in many Muslim countries<sup>33</sup>. If the moral argument was however paramount, consumption of the items would simply be banned.

The price-inelastic demand for alcoholic beverages and tobacco products means that even high taxes do not deter consumption very much, and “a widespread argument in some developing countries is that their primary effect is to deprive the families which use these commodities of funds for milk, and other items essential for health”<sup>34</sup>. At a minimum this suggests that the moral argument carries little force, although sumptuary taxes “appear to continue to enjoy public acceptance”.<sup>35</sup>

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<sup>33</sup> (for example, the 195 percent tax on beer in Mauritania)

<sup>34</sup> Due, J. (1994) *Excise taxes*. World Bank Policy Research Working Paper 1251. The World Bank, Washington, D.C. p27

<sup>35</sup> McLure, C. et al (1978) *The Inequity of Taxing Iniquity: A Plea For Reduced Sumptuary Taxes In Developing Countries*. *Economic development and cultural change*, p499

### **2.3.3 Equity**

Taxes must be perceived as being fair or equitable. Equity can be evaluated according to two principles: the benefit principle and the ability to pay principle. Given that tobacco consumption results in social costs, the benefit principle implies that a “user fee” must be levied on tobacco in proportion to the social costs incurred. In particular, since smokers consume publicly funded health care resources, advocates of a user fee approach to cigarette taxation argue that excise taxes should be imposed to force smokers to “pay their own way”.

The ability to pay principle to taxation has two dimensions: the horizontal and the vertical. According to the horizontal dimension, people in equal circumstances (usually defined in terms of income) should be taxed equally. According to the vertical dimension, affluent people should bear a proportionally greater share of the tax burden than poor people. For vertical equity, the poorest members of society should bear a very light tax burden, if any.

Difficulties however, begin when one tries to apply the criterion in practice. First, an assumption is needed about who actually bears the burden of a tax. Usually the supposition is that the burden is shifted onto the final consumer, but in many cases this may not be correct. Second, a measure of ability to pay is needed, which ideally should reflect one's permanent income rather than the income (or wealth) one happens to enjoy in a single year.

It is often held that excise taxes on cigarettes are regressive and therefore not vertically equitable. A regressive tax is one where the tax as a proportion of income is larger for poor people than for more affluent people. Given that (1) the prevalence of smoking is greater

amongst poor people, and (2) poor people in general spend a larger proportion of their income on tobacco products, an excise tax on tobacco is regressive.<sup>36</sup>

However, even though a given tobacco excise tax may be regressive, increases in the excise tax may not be. The reason is that poor people are more sensitive to changes in the price than rich people. An increase in the excise rate will result in a proportionally smaller increase in the tax burden of poor people than of more affluent people.<sup>37</sup>

Ideally one would want all individual taxes to satisfy the ability to pay principle. In the case of tobacco, it seems that the excise tax at any given one time does not satisfy the vertical dimension of this principle, while increases in the tax rate generally do. However, one should not become too fixated with the equity, or otherwise, of one tax, but should rather judge the fairness of a tax system whether the overall effect of all taxes is progressive or regressive.

The most common critic of excise taxes is that they are unfair<sup>38</sup>. Whether this is true depends in part on what one means by fairness. Some argue that it is fair that those who benefit from a good or service such as a road should pay for it. Shoup<sup>39</sup> claims that it is fair to levy corrective taxes, arguing that “being poor should not entitle one to an unlimited license to create negative externalities”. It is sometimes argued that alcohol taxes have a particularly harmful impact on women and children. The claim is that if alcohol taxes rise, total spending

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<sup>36</sup> Corné van Walbeek, “Impact of Tobacco Taxation on Consumption: The South African Experience” 11th Conference on Tobacco or Health, Applied Fiscal Research Centre, Cape Town , <<http://archive.idrc.ca/ritc/taxation.pdf>> viewed on 29th June 2009

<sup>37</sup> Woolery, T et al (2000). "Clean In door-Air Laws and Youth Access Restrictions." In Tobacco Control in Developing Countries, ed. Prabhat Jha and Frank Chaloupka, (Oxford: Oxford University Press), p273-286.

<sup>38</sup> Supra note 34

<sup>39</sup> *ibid*

on alcohol by the household will rise (because demand is inelastic), leaving less for essentials such as food, schooling, and clothing. There is another interesting possible gender effect: to the extent that alcohol taxes hit the formal sector, and beer in the informal sector is brewed by women, then higher alcohol taxes could lead to higher consumption of the latter, boosting the profits of the female brewers.

## 2.4 Cigarette Prices and Health

Tobacco kills one in two smokers who use cigarettes as intended by the manufacturer. According to statistics prepared by the World Bank, there are about 1.2 billion smokers ~out of a total population of around 6 billion, 80% of whom live in low and middle income countries.<sup>40</sup>

According to research undertaken by Barnum H,

“One third of all people aged fifteen years and over smoke. 82 000 to 99 000 young people start smoking each day. Smoking kills 4 million people a year worldwide (one in 10 adult deaths), and that toll will rise to 10 million per annum by 2030 (one in six deaths). The world tobacco market produces an annual global loss (due to the cost of treating tobacco related illnesses and lost earnings) of \$200bn (£125 000m), one third of which occurs in developing countries.”<sup>41</sup>

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40 The World Bank. *Curbing the Epidemic. Governments and the Economics of Tobacco Control*. Washington, DC: World Bank, 1999, <<http://www.globalink.org/tobacco/wb/>> accessed 17<sup>th</sup> August 2009.

41 Barnum H, (1994) *The Economic Burden of the Global Trade in Tobacco*, *Tobacco Control* <<http://www.bmj.com/cgi/content/full/320/7227/74>> accessed on 10th September 2009

Smokers are at a high risk of dying from smoking related conditions like lung cancer, heart disease, chronic obstructive lung disease, emphysema or bronchitis, circulatory disease and other cancers.<sup>42</sup>

In 1996, the World Health Organisation (WHO)<sup>43</sup> estimated that 3 million people worldwide died every year from smoking-related disease, 2 million in developed countries (DCs) and 1 million in developing countries (LDCs). Consumption trends indicate that smoking prevalence is reducing in developed countries (down 1.5% per annum in the United States) whilst increasing in lesser developed countries (up 1.7% per annum on average). Based on then current trends, WHO estimated the death toll from smoking would rise to 10 million people per year by the year 2025, 3 million per year in developed countries and 7 million per year in lesser developed countries. Currently, the annual death toll has increased to about 4 million or about one person every eight seconds.

No other consumer product in the history of the world has come even close to inflicting this degree of harm on the world community. If anything else posed a threat to life of this magnitude, whether human induced or naturally occurring - be it world war, genocide, ethnic cleansing, natural disaster or disease - it would demand immediate international action. The responses to war crimes (both current and dating back to World War II), germ warfare, nuclear weapons, HIV or even climate change are but a few examples. Due to the latency in the development of disease from smoking, the world community has been slow to respond to

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42 Francey N. "Tobacco Litigation; the Australian Experience in a Global Context" UICC Globalink <<http://www.globalink.org/tobacco/docs/ap-docs/0103francey1.shtml>> last viewed on 15th July 2009

43 Who estimates are taken from Tobacco Alert April 1996 "The Tobacco Epidemic : A Global Epidemic Health Emergency" accessible at the WHO website <[www.who/psa/toh/Alert/apr96/index.html](http://www.who/psa/toh/Alert/apr96/index.html)> last viewed on 30<sup>th</sup> July 2009



the tobacco epidemic which has been a phenomenon of the twentieth century, hence the WHO estimates for the year 2025.

According to a study conducted by Pacific Institute for Research and Evaluation and the Roswell Park Cancer Institute<sup>44</sup>, an increase of \$1 in the current cigarette excise tax, indexed for inflation, would result in 2.3 million fewer smoking attributable deaths over the projected 40-year period the study measures.

The greatest benefit from the tax hike would be to youth smokers who are, as a group, the most sensitive to price fluctuations, projecting that a \$1 cigarette tax hike would immediately decrease youth smoking by 30 percent while reducing overall smoking rates by 11 percent.

In another research carried out on British male doctors<sup>45</sup>, “34 439 British male doctors who replied to a postal questionnaire in 1951, of whom 10 000 had died during the first years and another 10 000 have died during the second 20 years. Results - Excess mortality associated with smoking was about twice as extreme during the second half of the study as it had been during the first half. The death rate ratios during 1971-91 (comparing continuing cigarette smokers with lifelong non-smokers) were approximately threefold at ages 45-64 and twofold at ages 65-84.”

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<sup>44</sup> Moolchan E. “Gender And Ethnic Predictors Of Adolescent Nicotine Replacement Therapy Use” <[http://roswelltturc.org/research/a22-borland\\_cross-countryc.pdf](http://roswelltturc.org/research/a22-borland_cross-countryc.pdf)> viewed on 15th August 2009

<sup>45</sup> Doll, R et al, “Mortality in relation to smoking: 40 years' observations on male British doctors Sutherland” <[http://www.bmj.com/cgi/content/abstract/309/6959/901?ijKey=8449b15bc641ba2f493905ed76768aefdbac156b&keytype2=tf\\_ipsecsha](http://www.bmj.com/cgi/content/abstract/309/6959/901?ijKey=8449b15bc641ba2f493905ed76768aefdbac156b&keytype2=tf_ipsecsha)> viewed on 17<sup>th</sup> August 2009

The excess mortality was chiefly from diseases that can be caused by smoking. Positive associations with smoking were confirmed for death from cancers of the mouth, oesophagus, pharynx, larynx, lung, pancreas, and bladder; from chronic obstructive pulmonary disease and other respiratory diseases; from vascular diseases; from peptic ulcer; and (perhaps because of confounding by personality and alcohol use) from cirrhosis, suicide, and poisoning. A negative association was confirmed with death from Parkinson's disease. Those who stopped smoking before middle age subsequently avoided almost all of the excess risk that they would otherwise have suffered, but even those who stopped smoking in middle age were subsequently at substantially less risk than those who continued to smoke. In conclusion, results from the first 20 years of this study, and of other studies at that time, substantially underestimated the hazards of long term use of tobacco. It now seems that about half of all regular cigarette smokers will eventually be killed by their habit.<sup>46</sup>

### **2.4.1 Finding the Sense in Smoking**

Until recent years, smoking and other addictive behaviours were assumed to be perfectly irrational. Instead of being guided by utility maximization, drug use, was believed, to be led by an uncalculating urge which had to be satisfied. The behaviour was seen as independent of costs and benefits, independent even of price. By the late 1970's, economists found this

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<sup>46</sup> *ibid*

interpretation of drug demand inconsistent with the canonical utility maximization and this in turn precluded any rigorous analysis of the cigarette market.<sup>47</sup>

In order to understand drug demand it is important first to define the characteristics of tobacco addiction. Cigarette use is distinguished as an addictive behaviour by two key factors; namely reinforcement and withdrawal. Reinforcement is a learned response to consumption, leading smokers to grow dependent on the rewards of tobacco use. For cigarettes, positive reinforcement comes in the form of both the pharmacological effects associated with nicotine and also the psychological benefits of lighting up.<sup>48</sup>

On the other hand, tobacco users are also influenced by negative reinforcement. They smoke to avoid negative stimuli such as stress or weight gain. Withdrawal is an extreme physical and psychological form of negative reinforcement, because a smoker's body and mind react adversely to the stoppage or reduction of cigarette consumption. The symptoms often include irritability, anxiety, and increased blood pressure. Given that the levels of reinforcement and withdrawal are a function of total consumption over time, past consumption has a bearing on the utility of smoking in the future.<sup>49</sup>

Tobacco use can thus be viewed as a rational and deliberate behaviour, although it is also addictive. Consequently, it is important to look at a consumer as the best judge of his own self-interest because the decision to consume tobacco is presumably rational. Government's

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<sup>47</sup> Chaloupka, F. et al (2000) "The Economics of Addiction." In *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka, (Oxford: Oxford University Press), p107- 129

<sup>48</sup> *ibid*

<sup>49</sup> *ibid* p110

attempt to regulate such behaviour in a liberalised economy is therefore seen as an encroachment on the individual's private space. The government's efforts are thus seen as limiting liberty and are therefore seen as being less effective in protecting the individual's self-interest compared to efforts made by the individual himself.

In the case of cigarettes, this principle implies that, so long as the benefits and costs of tobacco use are fully internalized by the consumers and producers, the government should be very cautious in intervening in individual decision-making. An important exception to this principle of consumer autonomy is the case of children. Children are not considered capable of making competent and rational decisions because of a general lack of knowledge and judgment to properly evaluate their own self-interest. Underage smoking clearly emphasises this point.

## **2.4.2 Teenagers' exuberance and their Failure to Assess the Risks of Smoking Cigarettes**

Over 90% of smokers start smoking in their teenage years.<sup>50</sup> During these years, teenagers who opt to smoke are often misinformed about the risk of addiction and the future costs of their behaviour. This in turn leads to decision making which can only be viewed as being irrational because of the costs it imposes on smokers later in life and this justifies government intervention in the tobacco market.

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<sup>50</sup> Gajalakshmi, G. et al.(2000) "Global Patterns of Smoking and Smoking-Attributable Mortality." In *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka, (Oxford: Oxford University Press), p11-39

The fact that young smokers tend to be misinformed about addiction cannot be disputed because many of them have unrealistic ideas about their ability to break the cigarette habit. A 1994 U.S. Department of Health and Human Services study of teen smokers found that 55% of past month smokers and 45% of daily smokers predict that they probably would not, or definitely would not, be smoking in five years<sup>51</sup>. Yet, in a follow-up study five years later, the researchers found that, instead of stopping, the teen smokers had maintained or increased their quantity consumed.<sup>52</sup> The ignorance displayed by teenagers may be viewed as a function of their lack of personal experience. Adults on the other hand, are aware of the effects of addiction from having observed the effects of the addiction on others as well as through personal experience unlike teenagers.<sup>53</sup>

In order for consumption of cigarettes to be considered part of a rational decision, it is important for consumers to understand addiction and also to reasonably care about the future. If consumers are too myopic, they will place an exorbitantly high discount rate on the long-term costs of smoking. This means they will place a high value on the pleasure they derive from smoking in the present while failing to take into account the future implications of cigarette addiction. This view will deceptively reduce the apparent cost of addiction in the teenagers eyes, as well as the costs of the long-term health effects.

In constructing models of human development, researchers have found that children are more myopic than adults.<sup>54</sup> Adolescents tend to ignore the future, and this short-sightedness is

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<sup>51</sup> Swarthmore College Writing Proposal; *Justifying the Tobacco Tax*

<<http://www.law.fsu.edu/journals/lawreview/downloads/254/tobactrn.pdf>>, viewed on 24<sup>th</sup> July 2009

<sup>52</sup> Kenkel, D. and Likwang C. "Consumer Information and Tobacco Use." In *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka. Oxford: Oxford University Press, 2000, , p177-214

<sup>53</sup> Supra note 46. p120

<sup>54</sup> Supra note 49

reflected in the U.S. Department of Health and Human Services finding that seven out of ten adult smokers regret their choice to start smoking.<sup>55</sup> Thus, when teenagers begin smoking they may suspect that smoking will lead to future costs, but the young smokers fail to properly internalize those costs in their decisions. They short-sightedly and in some instances unknowingly, impose these expenses on themselves and eventually regret as adults.

Teenagers' ignorance about the addictiveness of cigarettes combined with their lack of sound judgement leads to a failure in the cigarette market. This is because an adolescents' demand for cigarettes does not reflect either the real minimal private benefit of consumption or the future costs of addiction. It fails to properly account for costs that will be imposed on smokers in the future. Children are thus misled into forming a lifetime habit which is more harmful than they realize, and this justifies some form of government intervention.

### **2.4.3 Taxation as a means of rectifying the Imbalance in the Cigarette Market**

Although intervention need not be in the form of a tax, other methods have not been very effective. A case in point is the ban on the sale of tobacco to minors in the United States. Although tobacco smoking is illegal for minors in every state in the United States, according

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<sup>55</sup> Jha, P. et al (2000). "The Economic Rationale for intervention in the Tobacco Market." In *Tobacco Control in Developing Countries*, ed. Prabhat Jha and Frank Chaloupka, (Oxford: Oxford University Press), p158

to economists Frank Chaloupka and Michael Grossman in a 1996 study<sup>56</sup>, these minimum-age-at-sale laws have had little impact on the supply of tobacco to minors.

Another approach which has been taken is education, but its success is once again limited. There is no guarantee that teenagers who undergo anti-drug classes will be able to make rational decisions. Teenagers would still be myopic and would not be able to properly integrate such information into their decision-making.<sup>57</sup> This leaves us with the possibility of taxing cigarettes.

Primarily due to the impact of addiction, the market for cigarettes can be segmented into two, the market for teenagers and the market for adults. In the short run, there is a significant gap between the elasticities for adults and for minors. One study concluded that teenagers are up to three times more sensitive to price than adults.<sup>58</sup> Unlike adults, teenagers are not constrained by past consumption and do not have to contend with an addiction history. This means that teenagers' demand adjusts more dramatically to changes in the current price level of a commodity. This is in contrast to the adult market which is mainly composed of addicts. Adults' current consumption is based on their smoking history, level of addiction and their access to relatively large disposable incomes. Since an adult is likely to spend a smaller percentage of disposable income on cigarettes than a teenager, the adult's demand curve is all the more inelastic.<sup>59</sup>

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<sup>56</sup> Woolery, T. (2000) "Clean In door-Air Laws and Youth Access Restrictions." In Tobacco Control in Developing Countries, ed. Prabhat Jha and Frank Chaloupka, p273-286. (Oxford: Oxford University Press), p158

<sup>57</sup> Supra note 49

<sup>58</sup> estimates of teenagers' elasticity ran from 0.58 all the way up to 1.31 (supra note 23. p252).

<sup>59</sup> Supra note 23. p252

An increase in the price of cigarettes would therefore substantially decrease teen cigarette demand, while having a much smaller impact on adult consumption. As the demand curve for teenagers is relatively elastic, a tax increase reflecting the costs which teenagers irrationally impose on their future selves would substantially increase the market's efficiency. Leading health economists have concluded that, since adult demand is relatively inelastic compared to teenage demand, "the benefits from the large reduction in youth tobacco use resulting from a tax increase would be substantially larger than the losses incurred by adult tobacco users".<sup>60</sup>

The tobacco tax is therefore justified as a correction for teenagers' irrationally exuberant consumption. The greatest benefit from a tax hike would be to youth smokers who are, as a group, the most sensitive to price fluctuations.

Another argument for the tobacco tax is that it is a means of addressing negative externalities. According to a study conducted by Pacific Institute for Research and Evaluation and the Roswell Park Cancer Institute<sup>61</sup>: An increase of \$1 in the current cigarette excise tax, indexed for inflation, would result in 2.3 million fewer smoking attributable deaths over the projected 40-year period the study measures.

#### **2.4.4 Evaluating the External Costs and Benefits of Smoking**

An externality is either a cost or benefit that a transaction imposes on those not involved and that is not mediated through market prices. Tobacco externalities are either physical or financial. Physical externalities relate to second-hand smoke while financial externalities

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<sup>60</sup> *ibid* p265

<sup>61</sup> *Supra* note 49



relate to the costs of healthcare, sick leave, etc. Yet, the negative physical externalities of second-hand smoke tend to be ambiguous and easily corrected through less invasive measures than taxation, while the net financial externality of tobacco use is very close to zero.

The physical externalities resulting from second-hand smoke can be divided into two categories the adverse health effects and the effect of breathing second-hand smoke. In terms of the adverse health impact, it is difficult to differentiate between the external and internalized costs.<sup>62</sup> Environmental tobacco smoke affects the health of those who are chronically exposed who are mostly family members. Since the economic decision-making unit is often considered to be the family, the smoker is often assumed to take into account the total health risks of second-hand smoke. The same argument applies to babies' health problems due to exposure to nicotine during pregnancy. The mother may internalize these extra health care costs in her own decision-making.<sup>63</sup>

Second-hand cigarette smoke is also a nuisance to non-smokers in terms of its odours and physical irritation, but the response to this need not be taxation.<sup>64</sup> The nuisance of second-hand smoke is clearly a negative externality and is a good argument for a Pigouvian tax. To rectify the nuisance, a tax may be seen as being less effective and too intrusive. A more appropriate approach would be to limit smoking in public areas.

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<sup>62</sup> Supra note 52

<sup>63</sup> Supra note 23, p261

<sup>64</sup> Supra note 53, p159

The negative financial externalities that smokers impose on society are also frequently cited as another justification for upping the price of tobacco. These negative financial externalities are apparent and can be easily computed. Smokers impose a large external health care cost. This external cost can be calculated as the portion of the total health care bill due to cigarette use for which smokers do not pay. On most occasions these costs are passed on through to other members of society, for example increments in insurance premiums. The labor market is also negatively affected, as smokers tend to take more days of sick leave. Indirectly, smokers' poor health also has an adverse effect on government revenues, as the smoking-related deaths of productive workers cut into tax proceeds.

Some researchers argue that these large negative externalities are counterbalanced by smoking's positive externalities.<sup>65</sup> Cigarette use, by cutting down smokers' life spans, saves society certain large expenses related to elderly care and living. The primary savings are found in public and private pension plans. Many smokers who contribute to pension plans until around retirement age die before they can claim a substantial portion of their benefits.<sup>66</sup> As the required pension contributions are not lower for smokers, the savings are passed on to the rest of society.

Although the tobacco tax is justified as a correction on an inefficient market, its purpose should not be seen as addressing the harm that smokers impose on others. Instead, the tobacco tax should be regarded as a tool to minimize the unforeseen and unintended costs that adolescent smokers impose on their future selves. The tax can also be seen in another light as a relatively efficient source of government revenue.

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<sup>65</sup> Supra note 49

<sup>66</sup> Supra note 53, p161

## 2.4.5 The Revenues

As it has for many years, the tobacco tax continues to provide healthy revenue streams to many governments with relatively little welfare loss. In order to maximize the efficiency of consumption taxation, the Ramsey Rule dictates that the level of taxes imposed on a good should be inversely related to the price-elasticity of demand. The demand for cigarettes is relatively inelastic as compared to other products, especially in the short run, and so, under the Ramsey rule, tobacco should be subject to a relatively high tax rate. Although the duty dissuades tobacco use among parts of the population, the overall elasticity is such that the tobacco tax yields reasonable government revenues, in the US it is approximately \$12 billion per year with relatively little welfare loss.<sup>67</sup>

The tobacco tax in the US is a drop in the bucket in terms of the total U.S. government revenues (composing only 0.41%) but it is essential to specific earmarked programs.<sup>68</sup> Increasingly, many states and local governments have set aside tobacco funds for specific uses. In such states as California, Massachusetts, Arizona, and Oregon, tobacco tax funds are geared towards tobacco-related education, counter-advertising, and health care for those who are underinsured. By making such programs politically feasible, tobacco tax revenues have a bearing on public policy.

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<sup>67</sup> Supra note 53, p161 and note 23, p254

<sup>68</sup> Supra note 23

## 2.4.6 The Tax's Potential Detriments

While the tobacco tax efficiently raises government revenues and protects children from the overuse of tobacco, the tax has certain potential detriments. The tax, violates the principles of vertical and horizontal equity. It also represents an affront to consumer autonomy. Despite these detriments, the tobacco tax is a justified public policy measure, whose benefits of raising revenues and protecting children outweigh the tax's negative impact.

Vertical equity requires that individuals with the greatest ability to pay should be taxed more heavily, but the duty on cigarettes undermines this principle.<sup>69</sup> The cigarette tax, like many forms of sales tax, is regressive because lower income individuals devote a higher percentage of their income to paying the tobacco tax than do higher income individuals.

The tobacco tax is further seen as being regressive when one considers the fact that lower income individuals actually pay more tobacco taxes per capita than those with higher incomes. This is mainly because of the inverse correlation between income and education, on the one hand, and smoking, on the other. As people of lower socioeconomic status tend to have higher smoking rates, they pay more tobacco tax.

Although the tobacco tax is itself regressive, raising the tax is progressive, because lower income smokers are more sensitive to changes in price than higher income smokers. A 1998 Center for Disease Control study found that the price-elasticity of demand for those in families at or below the U.S. median household income was 70% larger than for persons in

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<sup>69</sup> *ibid* p257

families above the median.<sup>70</sup> Therefore, as the tobacco tax rises, the smoking prevalence gap between the socioeconomic classes closes, and the incidence of the tax becomes more equitable. In other words, an increase in the tobacco tax tends to make the tax less regressive.<sup>71</sup>

The challenge of remedying the tobacco tax's violation of horizontal equity is however greater. Taxing identical people who consume different quantities of tobacco at different rates is not feasible because it is unfair to the many smokers who impose neither externalities on society nor unreasonable costs on their future selves. Such smokers include those who are able to cater for their own medical expenses when they become sick and may include a pregnant mother who takes into account the implications of her actions on the health of her unborn child. In such instances, it is neither easy to avoid nor rectify the imbalance.

The costs to horizontal equity must be weighed against the tax's substantial benefits including the benefit of protecting children from the harm in the cigarette market and also efficiently raising government revenue. The benefits of the tobacco tax in terms of protecting children and raising revenues far outweighs any harm it does to horizontal equity.

Finally, the tobacco tax is often seen as a violation of personal autonomy. Great value is placed by society on consumer freedom and allowing individuals to choose the best course for themselves, provided that the decisions do not impose external costs on others. The danger in too much government involvement is that the government may encroach into

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<sup>70</sup> *ibid* p253

<sup>71</sup> *ibid* p258-259

individual's private lives. Some have interpreted the tobacco tax "as a troubling, unjustified attempt by the government to impose values on the citizenry."<sup>72</sup>

Such alarmism is belied by a unique justification for the tobacco tax that children are irrationally imposing particularly large costs on their future selves through addiction. Society has long differentiated minors from adults. It has long been recognized that children should not have full personal autonomy, as they do not have the same ability to make rational decisions hence the age limits for voting, driving, drinking, etc.

The tobacco tax is fully consistent with this precedent as its key purpose is to transform the behaviour of young people. The tax's impact on the behaviour of adults is an unavoidable by product that represents a detriment of the tobacco tax, but this effect is relatively small due to the inelasticity of adult demand. If anything, the tobacco tax, as an intervention in the market, is meant to expand personal autonomy the personal autonomy of tomorrow's adults who will no longer be constrained by the irrational, youthful decisions of today.

## **2.5 Myths about the Impact of Tobacco Taxation**

### **2.5.1 Revenue Losses**

Revenues actually rise with taxes, particularly in countries where taxes comprise a relatively low share of prices; average revenue increases from 10% tax increase would exceed 7%.

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<sup>72</sup> Viscusi, W. Kip. (1995) "Cigarette Taxation and the Social Consequences of Smoking." *Tax Policy and the Economy* 9: p51-101

## **2.5.2 Job Losses**

Job losses in the industry, if any may be temporary, minimal, and gradual. Most countries would benefit in the short and long run from the reduced tobacco sales resulting from higher tobacco taxes as money once spent on cigarettes is spent on other goods and service.

## **2.5.3 Smuggling**

Smuggling of tobacco products is generally overstated by tobacco manufacturing companies with the main aim of discouraging countries from raising taxes on their products. The companies claim that consumers are tempted to purchase smuggled goods whenever there is an increase in prices because the smuggled goods are cheaper. The appropriate solution is to crack down on the criminal activity, as opposed to foregoing the benefits of higher tobacco taxes.

## **2.5.4 Cost to Individuals, especially the Poor**

The cost to individuals is partially offset by lower consumption and it can be offset further by using additional tax revenues to finance programs targeting low income populations. The success of the strategy would be directly proportional to the elasticity of demand which is defined as the percentage change in quantity demanded divided by the percentage change in price. Recent studies indicate that the price elasticity of demand for cigarettes by adults in the USA is approximately -0.4, meaning that a 10 percent increase in price should create a 4 percent decrease in demand. A substantial portion of this decrease seems to result from a

decrease in smoking prevalence through cessation and falling incidence, rather than through less smoking by continuing smokers.<sup>73</sup>

The elasticity of demand for cigarettes has been shown to be considerably greater in groups with lower levels of disposable income, namely teenagers and people of low socioeconomic status; such groups will stop smoking at a faster rate than those with higher disposable incomes if the price of cigarettes rises, and they may be influenced not to start smoking because of the additional financial burden.<sup>74</sup>

As excise is only a fraction of the final retail price, a change in excise would normally be expected to cause a proportionately smaller change in price which implies that the price elasticity exceeds the excise elasticity of demand. Irrespective of the relative magnitude of these coefficients, the present results suggest that the consumption of tobacco products can be manipulated through variations in the excise rate. If these demand characteristics are typical of developing countries, this finding may have enormous implications for smoking control in the Third World. Such countries often have diverse linguistic subcultures which mitigate against mass communication in health education. Being oriented toward problems of infectious disease and malnutrition, their health services typically accord low priority to smoking control.

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<sup>73</sup>Scollo, M et al "Impact of tobacco tax reforms on tobacco prices and tobacco use in Australia"  
<<http://www.pubmedcentral.nih.gov/articlerender.fcgi?artid=1766108>> viewed on 22<sup>nd</sup> September 2009

<sup>74</sup> *ibid*



## **2.6 Conclusion**

The tobacco tax is justified, but the question remains, "At what level?" The goal of saving lives should not lead the government to sacrifice people's freedom of choice and social welfare by pushing rates too high. The challenge for both economists and public leaders is to calculate and legislate a tax level that maximizes social welfare, a tax level that most efficiently raises revenues, while preventing young children from lighting up due to their own ignorance and myopia.

## CHAPTER THREE

### 3.0 A COMPARATIVE STUDY OF TOBACCO TAXATION

*“As a government we are concerned about the ill-health caused by tobacco, but at the same time we cannot ignore the economic and social benefits the crop brings to our country.”*

*Dr Kibirige Sebunya<sup>75</sup>*

#### 3.1 Introduction

Tobacco control policies usually rest on a number of pillars. The most important of these are:

- (1) Increases in the real excise rate on tobacco;
- (2) Advertising restrictions;
- (3) Restrictions on smoking in public and/or work places; and
- (4) Awareness and education campaigns about the negative effects of tobacco use.

A recent review of studies conducted in high, middle, and low income countries found that tax increases resulting in higher tobacco prices were the most effective intervention available to governments to reduce demand for tobacco.<sup>76</sup> The greatest sensitivity to price increases was found among younger men and women, those from the lower income levels, and those with lower education levels.<sup>77</sup> Townsend *et al* in the United Kingdom found prices to be more

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<sup>75</sup> Mutumba-Lule A. “We’ll Curb Smoking, But...” The East African (Ke), 18<sup>th</sup> June 2001

<sup>76</sup> Scollo M. et al, “Impact of Tobacco Tax Reforms on Tobacco Prices and Tobacco Use in Australia”

<[http://tobaccocontrol.bmj.com/cgi/content/full/12/suppl\\_2/ii59#R1](http://tobaccocontrol.bmj.com/cgi/content/full/12/suppl_2/ii59#R1) > last accessed on 10<sup>th</sup> September 2009

<sup>77</sup> *ibid*

effective in reducing demand for tobacco than health information to people from lower socioeconomic groups.<sup>2</sup>

### **3.2 Excise Tax in Kenya**

The excise duty regime in Kenya is administered by the Kenya Revenue Authority under the Customs and Excise Act. The Customs and Excise Act Cap 472 in its preamble states that it is “An Act of Parliament to provide for the management and administration of the customs, for the assessment, charge and collection of customs and excise duties and for matters relating thereto and connected therewith.”

The Act defines "excisable goods" as goods manufactured in Kenya or imported into Kenya on which an excise duty is imposed under Act. “Excise duty” is defined as a duty of excise imposed on goods manufactured in Kenya or imported into Kenya and specified in the fifth schedule.

The Act also gives a definition of the words “similar goods” as goods which have similar

- (a) characteristics;
- (b) components
- (c) quality and reputation

which make them commercially interchangeable in the performance of functions

"identical goods" on the other hand are defined as goods which-

(i) are the same in all respects, including physical characteristics, quality, and reputation with the goods being appraised, minor differences in appearance notwithstanding;

(ii) are produced in the same country as the goods being appraised; and

(iii) were produced by or on behalf of the person by or on behalf of whom the goods appraised were produced,

but does not include imported goods where engineering, development work, design work, plans or sketches undertaken in Kenya were supplied, directly or indirectly, by the purchaser of those goods free of charge or at a reduced cost for use in the production and sale for export of those goods;

The definition of excisable goods, given the above definitions may create some confusion on which goods fall in the same category and thus can be charged the same tariff.

In **KEROUCHE INDUSTRIES LIMITED V KENYA REVENUE AUTHORITY & 5 OTHERS [2007] eKLR** the applicants moved to court seeking orders to prohibit the Respondent from removing the Applicant's fortified wine products from the classification under the Harmonised System (HS) Code Tariff Heading 22.04. Justice Nyamu on page 57 held that " the applicant had successfully demonstrated that it has a legitimate expectation, that it would not be abruptly and unilaterally, transplanted from tariff 22.04 which has been

the basis of its business and its business plans and projection for over nine years. In particular the legitimate expectations include:-

- a) there would be legal certainty in the classification of goods, products or services
- b) the Respondents would not renege on its decision to tax the applicant under tariff 22.04
- c) any subsequent **changes** or reconsideration of the tariff classification affecting its tax obligation would be done in consultation with it, in accordance with the relevant law and would not be applied retrospectively
- d) the respondents would make their decisions with fairness to all tax payers with the same products
- e) the respondents would not exercise their discretion in bad faith or in any unlawful manner or abuse their powers to achieve an improper motive or purpose
- f) the respondents would not abuse their powers to selectively victimize or punish the Applicant.

The court's finding here is that the respondents have threatened to thwart the above legitimate expectations and the court must come to the defence of legitimate expectations because, fair bargains ought not to be thwarted- this being a principle of fairness. The court would therefore uphold the above expectations."

In the case of **COMMISSIONER OF INLAND REVENUE THE DUKE OF WESTMINSTER [1986] AC I at page 24**. Lord Russel stated as follows:-

“I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed, if in accordance with the court’s view of what it considers the substance of the statute. the subject is not taxable by inference or by analogy but only by plain words of a statute applicable to the facts and circumstances of the case. As Lord Cairns said many years ago in **PARTINGTON V ATTORNEY GENERAL** “ As I understand the principle of fiscal legislation it is this, if the person sought comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown seeking to recover the tax cannot, bring the subject within the letter of the law, the subject is free however apparently within the spirit of the law the case ought otherwise appears to be ...”

In the case of **SCOTT V RUSSELL (INSPECTOR OF TAXES) TC 394** at pg 424, Lord Simonds observed:

“that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax on him.”

"smuggling" means the importation, exportation or carriage coastwise, or the removal from or into Kenya of goods with intent to defraud the customs, or to evade any prohibition of, restriction on regulation or condition as to, importation, exportation, carriage coastwise or removal, of goods;

Excise duty rates applicable in Kenya are both ad valorem (tax based on the price or value of the tax base) and specific (tax based on the weight or size of the tax base).

In Kenya, excise duty is taxed on the following items set out in the Fifth Schedule:

“Alcohol- including beer, wines, spirits: kshs. 50-85 per litre, Soft drinks, mineral water and juices: 10% or kshs 6 per litre, Cigarettes and other tobacco products: kshs. 500-2,000 per mille Petroleum products: kshs. 3.7-19.8 per litre, Cosmetics: 10%, Vehicles: 20%, Used motor vehicle spare parts: 20% or shs.10 per kg, Jewellery and precious stones:10%, Casino and gambling services: 5%, Mobile cellular and wireless services: 10%, Plastic bags: 120% and Used computers: 25 %”<sup>78</sup>

Under the Fifth Schedule, Part II, the Commissioner may from time to time through a notice in the Gazette adjust the retail selling price for cigarettes and for this purpose, the commissioner may require manufacturers and importers to submit any information relating to manufacturing and pricing of excisable goods.

Section 111 (2) of the Customs and Excise Act Booklet 1 provides that “A tobacco licensee shall not, save with the permission of the Commissioner and subject to such conditions as he may impose, sell or otherwise dispose of tobacco which is not liable to duty.”

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<sup>78</sup> DCDM Associates Kenya & Githongo “Kenya Tax Information Series; Excise Duty in Kenya” *Tax Bulletin* April – June 2009 <<http://www.dcdm.biz/resources/kenya-A-J 2009Newsletter.pdf>> accessed on 9<sup>th</sup> September 2009

Under sub-section (3) a tobacco licensee who contravenes this section or any condition imposed by the Commissioner in accordance with this section shall be guilty of an offence and any excisable goods or materials in respect of which the offence has been committed shall be liable to forfeiture.

On the other hand, the Tobacco Control Act, Chapter 4 of 2007 section 12 states that the Minister for the time being in charge of finance shall -

- (a) implement tax policies and where appropriate, price policies on tobacco and tobacco products so as to continue to the objectives of this Act;
- (b) prohibit or restrict, as appropriate, any sale to, or importation of tax-free tobacco products by international travellers.

Historically, excise taxes in Kenya were levied on the domestic production of only four product groups, namely cigarettes and tobacco, sugar, beer and spirits, and matches. According to the statistics available during the period between financial years 1980 to 1990, cigarettes and tobacco accounted for an average of 58% of total excise revenue while alcoholic beverages, sugar and matches accounted for 22%, 19% and 1% respectively. Cigarettes were subject to an ad valorem rate of excise tax while beer and spirits, sugar, and matches were subject to specific rates of excise tax.<sup>79</sup>

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<sup>79</sup> Supra note 7



During the entire period, beer and cigarettes were produced domestically by one large manufacturer for each product, namely Kenya Breweries Limited (KBL) and British American Tobacco (BAT) respectively. Prices of all commodities in Kenya were controlled by the central government up to 1993 when the market was liberalised. As a result it was common practice at that time for the government to continuously adjust upwards not only the excise tax rate but also the ex-factory value of these products in order to adjust for increases in the cost of production and inflation. There was no clear policy influencing the selection of the four products for excise taxation other than revenue considerations.

The Kenya Revenue Authority is in charge of ensuring that excise duty is charged by manufacturers. Tobacco companies in Kenya are required by law to charge excise duty on their products and this charge is ordinarily passed on to consumers by charging higher prices on their products.

According to a Report<sup>80</sup> published in August 2008, cigarette prices increased due to the rising taxes for manufacturers which compelled consumers to shift to less expensive brands. According to street vendors interviewed in the report, many Sportsman consumers changed to Safari following the increase in excise tax which was passed down to the consumer by producers.

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<sup>80</sup> Euro monitor International "Tobacco in Kenya Market"< [http://www.euromonitor.com/Tobacco\\_in\\_Kenya](http://www.euromonitor.com/Tobacco_in_Kenya)> accessed on 7th July 2009

This demonstrates the fact that excise duty in the tobacco industry greatly affects consumer behaviour especially the 'low-end' consumers because since they cannot afford to live sustainably with an increase in price. They thus end up decreasing their consumption, opting for lower priced products or adopting the use of illicit products.

Excise taxes have also been an important component of total tax revenue in Kenya. This is clearly evident from the fact that variations in excise tax are always made by the Finance Minister when reading the budget. The fact that the Finance Minister did not increase excise tax on tobacco products in the 2009/2010 financial year is the exception rather than the norm.

Kenya, like most developing countries has not shown any attempts to link the management of health issues with the imposition of excise tax on tobacco products. This is evident from the fact that little research has been undertaken into the far reaching implications of smoking on the masses in Kenya. Little data exists to show any emerging trends. The government has also failed to make any reference to health issues when imposing excise tax on harmful products like tobacco and alcohol, clearly showing that the concern is more with ensuring that the government has a steady supply of revenue.

The imposition of excise tax on cigarettes is done by the Minister of Finance with no involvement of other Ministries like the Ministry of Health which is responsible for the health of the country's citizen. The government has shown little initiative to address issues related to tobacco smoking and it is only after great lobbying that the Tobacco Control Act came into force.

Kenya is a signatory of the Framework Convention on Tobacco Control which requires parties to provide rates of taxation for tobacco products and trends in tobacco consumption in their periodic reports to the Conference. This requirement has not been met and it is important for the country to step up its efforts if it is to win the war against tobacco and its negative effects.

Civil society needs to lobby the government to ensure that alongside meeting its revenue goals, the government also fulfills its obligations to promote good health.

### **3.3 SOUTH AFRICA'S EXPERIENCE WITH TOBACCO EXCISE TAXES**

Excise duties on tobacco products are not new in South Africa and has been a source of government revenue since 1910. Tobacco excise taxes as a percentage of total government revenue increased from about 2.4 per cent in 1920 to more than 7 per cent during the 1950s<sup>81</sup>. Subsequently this percentage dropped to less than 2 per cent during the 1980s.

Excise taxes on cigarettes in South Africa are levied as a specific tax, expressed as an amount per 10 cigarettes. In times of rapid inflation the rate is adjusted regularly to prevent it from being eroded. During the low-inflation years before the early 1970s the excise rate on

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<sup>81</sup> Supra note 36

cigarettes did not need to be adjusted regularly. After the 1970s and especially during the 1980s the government was extremely reluctant to adjust the excise rate on cigarettes. Between 1970 and 1990 the nominal excise rate increased at an average rate of only 5.6 per cent per annum while the average inflation rate was 12.5 per cent. During this period the real excise rate fell by 72.4 per cent.<sup>82</sup>

After 1994, the Government of National Unity gave public prominence to the public health consequences of smoking in the spotlight. In 1994 the Minister of Finance announced that the government would increase the excise rate on cigarettes to a level where 50 per cent of the retail price would consist of excise tax to be phased out over a number of years. This position has however softened in subsequent years.

However, since 1991 the industry increased the producer price radically and in 1999 the real producer price was 91 per cent higher than in 1991 and 58 per cent higher than in 1994. The increase in excise rate together with the even more rapidly increasing producer price has resulted in the doubling of the real retail price of cigarettes.

The increase in retail prices has had positive consequences for tobacco control. An increase in the price of cigarettes, irrespective of whether this is due to an increase in excise tax or greater profits by cigarette manufacturers, will decrease cigarette consumption. Since the increase in excise is well-publicised, cigarette manufacturers are able to blame the

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<sup>82</sup> *ibid*

government for the increase in the price, even though they are equally responsible for increasing the retail price.

The rapid decline in cigarette consumption during the 1990s is a tribute to the government's tobacco control policies. The mainstay of the government's anti-tobacco policy was the increase in excise rates, even though such increase can also be attributed to the increase in producer prices.

South Africa is one of a limited number of developing countries that has implemented a comprehensive tobacco control policy. This has resulted in large increases in the real price of cigarettes, significant reductions in tobacco consumption and a large increase in excise revenues by the government.<sup>83</sup>

In an open letter to the Minister of Health in October 1996, the Rembrandt Group (South Africa's largest cigarette manufacturer and distributor) claimed that substantial increases in the excise duty would result in increased smuggling. The group cited the example of Canada where the government lost revenue when it increased the excise rate on cigarettes because of increased smuggling. No evidence however exists to show that increased tobacco smuggling has impacted significantly on government revenue. Instead statistics show that since 1996 real excise revenues increased by 59 per cent in response to a 91 per cent increase in the real excise rate. This implies a total revenue elasticity of 0.64 for this period, the same as the preceding three years. If there had been a major increase in smuggling, the revenue elasticity would have been considerably lower after 1996.

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<sup>83</sup> *ibid*

### 3.4 United States of America

An expert working group convened by the American Heart Association recommended an increase in the rate of excise taxation on tobacco products and the resulting increase in tobacco prices as the leading priority for the United States among a range of smoking control strategies. According to the group “The success of the strategy would be directly proportional to Recent Tax Increases.”<sup>84</sup>

Many of the most recent tax increases earmark most of the new revenues generated for health related programs, including expanded public health insurance programs and comprehensive tobacco control programs.

Evidence from U.S. suggests that youth are up to three times more sensitive to price than adults while young adults are about twice as price sensitive. Studies conclude that the greatest impact of price is in preventing transitions from experimental smoking to more regular smoking. Because kids are highly price sensitive and 90 percent of smokers start as teens, higher taxes can sharply reduce smoking in the long run.<sup>85</sup>

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<sup>84</sup>C haloupka F, “Tobacco Taxation” <<http://www.impactteen.org>> viewed on 20th June 2009

<sup>85</sup>U.S. Department of Health and Human Services, *Investment in Tobacco Control: State Highlights 2001* Centers for Disease Control and Prevention, National Center for Chronic Disease prevention and health Promotion, Office on Smoking and Health <<http://www.impactteen.org>, <http://www.uic.edu/~fjc>> viewed 5<sup>th</sup> June 2009

In the US, tobacco regulation is governed by state regulations and it therefore follows that different states have different legislation. In New York a price increase of 55 Cents in March 2000 led to a 20% drop in price with a commensurate increase in tax revenues. California's tobacco control program began in January 1989, when the excise tax was increased from \$0.10 to \$.35 per pack of cigarettes. On November 3, 1998 California voters approved Proposition 10, a measure that increased the state tax on cigarettes by 50 cents per pack starting January 1, 1999, to a total of 87 cents tax per pack. The increase made California's tax per pack of cigarettes the fourth highest amongst the states - only New York's, Hawaii's, and Alaska's taxes are greater.<sup>86</sup>

Initially, following the 1989 excise tax increase, consumption decreased rapidly. Overall tobacco use in California declined throughout the 1990s at a rate two or three times faster than that in the rest of the country. Between 1988 and 1999, per capita cigarette use in California declined by almost 50%, while in the rest of the country it declined by only about 20%.<sup>87</sup>

Between 1995 and 1999, the prevalence of cigarette use among youth dropped by 43% in California. By virtue of its duration and intensity, the California program also has the distinction of being the first program to demonstrate a reduction in tobacco-related deaths.<sup>88</sup>

The Massachusetts Tobacco Control Program (MTCP)<sup>89</sup> was created through a state wide referendum held in November 1992 and is entirely funded by a tax on cigarettes and

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<sup>86</sup> *ibid*

<sup>87</sup> *ibid*

<sup>88</sup> *Supra* note 93

<sup>89</sup> *Supra* note 85

smokeless tobacco products. Since its introduction through June 1999, program successes include:

- a. Massachusetts has seen more rapid declines than states without tobacco control programs in the overall prevalence of tobacco use among adults.
- b. Rates of smoking among Massachusetts youth have declined sharply, with smoking dropping 70% among 6th graders from 1996 to 1999.
- c. Cigarette consumption has fallen by 33%, while consumption in the rest of the country declined just 10%.
- d. The number of adult smokers has declined
- e. Smoking during pregnancy dropped sharply, from 25% to 13%
- f. Youth smoking rates in Massachusetts from 1996-1999 have declined at a greater rate than the rest of the country
- g. The number of smokers planning to quit has increased, and those who try to quit are more successful.

### **3.5 WHO Framework Convention on Tobacco Control (FCTC)**

The WHO Framework Convention on Tobacco Control (WHO FCTC) is the first treaty negotiated under the auspices of the World Health Organization. It was adopted by the World Health Assembly on 21<sup>st</sup> May 2003 and entered into force on 27<sup>th</sup> February 2005. It has since become one of the most widely embraced treaties in UN history has over 166 members.<sup>90</sup>

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<sup>90</sup> “WHO Framework Convention on Tobacco Control”, <<http://www.who.int/fctc/en>> viewed on 2<sup>nd</sup> October 2009



The WHO FCTC was developed in response to the globalization of the tobacco epidemic and is an evidence-based treaty that reaffirms the right of all people to the highest standard of health. Concern has been driven by the recent expansion of Transnational Tobacco Corporations (TTCs) across many low- and middle-income countries. This has led to the burden of tobacco's health effect shifting. It is predicted that, by 2030, 70% of the estimated 10 million global deaths from tobacco will occur in developing countries.<sup>91</sup> In this context, sub-Saharan Africa (SSA) offers an opportunity for global health, being the only region in the world where primary prevention of the tobacco epidemic remains possible.<sup>92</sup> However, with TTCs investing heavily in the region during the last decade and with evidence of rapidly rising consumption, particularly among youth<sup>93</sup>, this window of opportunity is closing rapidly.

The Convention represents a milestone for the promotion of public health and provides new legal dimensions for international health cooperation. It represents a paradigm shift in developing a regulatory strategy to address addictive substances. In contrast to previous drug control treaties, the WHO FCTC asserts the importance of demand reduction strategies as well as supply issues.

Some of the specific provisions for national authorities to consider in legislation and regulations include:

- a. increased taxation maintained above inflation rates;

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91 Patel P. et al (2007) "The law was actually drafted by us but the Government is to be congratulated on its wise actions: British American Tobacco and public policy in Kenya"

<<http://tobaccocontrol.bmj.com/cgi/content/full/16/1/e1>> accessed on 7th September 2009

<sup>92</sup> *ibid*

<sup>93</sup> *Supra* note 110

- b. bans on advertising, sponsorship, and promotion;
- c. bans or restrictions on smoking in public places;
- d. requiring prominent health warnings and messages on tobacco packages and in any allowed advertisements, sponsorships, and promotions;
- e. requiring constituent labels and additive levels and testing methods;
- f. prohibition on sales and distribution of tobacco products to and by minors

Evidence from tobacco industry documents; however, reveal that tobacco companies have operated for many years to deliberately subvert the efforts of the WHO to control tobacco use. The attempted subversion has been elaborate, well-financed, sophisticated, and usually invisible.<sup>94</sup>

Because of this significant opposition, the WHO subsequently constituted the Tobacco Free Initiative (TFI) to provide structured assistance to countries in adhering to the FCTC. A key component of the initiative is to monitor the tobacco industry and inform member countries of industry practices.

Findings support the need for assistance like that of the TFI in establishing tobacco control measures: “Funding is needed not so much to implement programs as to fight off tobacco industry tactics and to build popular support for control... the most obvious constraint to tobacco control is political opposition, which is difficult to deal with.”

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<sup>94</sup> International Resource Center “Kenyan Parliament Passes Strong Anti-Tobacco Legislation”  
<[http://www.tobaccofreecenter.org/press\\_release/2007/09/05/](http://www.tobaccofreecenter.org/press_release/2007/09/05/)> as at 7th June 2009

### **3.6 Conclusion**

Kenya, like most countries, imposes excise tax on products it considers harmful to individuals and society like tobacco products and alcohol and also luxuries like perfumes. The main aim is to raise revenue and it is only in subsequent years that the issue of health considerations in imposing excise tax on cigarettes has become important. The increase in price as a result of an increase in excise tax therefore serves the interest of the government in raising revenue and also acting as a deterrent for those who have not acquired the habit

Most strides in regulating behaviour have been made in the developed countries. Developing countries have shown little or no interest in enforcing health matters through the imposition of taxes. It is only after intense lobbying that banning of smoking in public areas was imposed in Kenya.

Substantial increases in cigarette and other tobacco product prices, including those resulting from significant increases in tobacco excise taxes, lead to large reductions in tobacco use and, in the long run, reduce the public health toll caused by tobacco use.

Earmarking revenues generated from increased tobacco taxes for comprehensive tobacco control programs leads to significant reductions in overall smoking and in the prevalence of youth smoking.

## **CHAPTER FOUR**

### **4.0 CONCLUSION AND SUGGESTIONS ON THE WAY**

#### **FORWARD**

#### **4.1 Introduction**

One of the most cost effective ways of controlling tobacco consumption, especially in low income countries, is to raise the price of cigarettes through increasing tobacco taxes. Every tobacco tax is therefore a health decision and maintaining the price of tobacco above the rate of increase in real incomes is an important public health goal. Promotion of good health principles and collection of revenue by the government are not mutually exclusive; both can be successfully pursued without occasioning any harm to the other.

Many developing countries like Kenya have not embraced the fact that excise tax can serve a further complimentary role of regulating behaviour by linking increments in excise tax with the need to promote good health. Excise tax is seen mainly as a tool for generating revenue with little regard to the fact that it can act as a tool for regulating behaviour. Cigarette smoking and its negative implications on human health cannot however be overlooked because of the serious ramifications involved.

An increase in tobacco taxes would not only reduce consumption but would increase revenues for cash-strapped governments. If part of these new revenues were spent on health service, there would be a double benefit for health arising from reduced tobacco consumption and increased health spending.

It is important to evaluate the tobacco tax in light of the rules of economic efficiency and widely accepted social values. First, it is important to note that an individual's decision to smoke is potentially rational and utility maximizing. Given that most smokers fall into the habit as adolescents, their capacity for rational decision-making is rarely realized due to a failure on the individual's part to consider the future implications of their decisions. The elasticity of demand in the tobacco market shows that it is relatively inelastic for adults and elastic for children, which makes the tobacco tax a particularly effective and efficient correction for overly exuberant youth tobacco consumption.

This research has also established that smoking imposes negative externalities on society. The tax potential benefit has been noted, as well as its potential detriments, while discussing the feared consequences for equity and individual autonomy. Weighing this analysis, it is necessary to conclude that the benefits of the tobacco tax exceed the costs. While not flawless, the tobacco tax is justified as a correction on a market that does not adequately account for the risks of smoking and justified as an efficient source of government revenue.

## **4.2 Recap on the Role of Excise Tax in Correcting Negative Externalities**

The use of cigarettes and other tobacco products has unintended health care costs that arise from the disease and deaths of tobacco users, particularly smokers and others who inhale their smoke (e.g., smokers' health care costs due to smoking, and the costs of the disease and deaths non-smokers suffer from second hand smoke).

Imposing a tax on the smoker that incorporates the negative external costs of that smoker's actions on non-smokers is one way of ensuring that smokers are responsible for the burden they impose on society. This is because the smoker pays for the higher, societal cost and he/she is forced to make a more economically efficient decision on whether and how much tobacco to purchase. If the external cost—and incorporated tax level—is high enough, the smoker consumes less and the external costs of smoking are ultimately lowered.

Imposing a very high tax on tobacco (which is seen as a high initiation cost to the young person and therefore a deterrent) helps to persuade the potential smoker not to start. More importantly, sustaining a high tax on tobacco over a long period reduces use by successive groups of teenagers and has a lasting impact on aggregate consumption. Protecting children from smoking and its associated health risks is therefore the most compelling argument for increasing tobacco taxation.

### 4.3 The Impact of Tobacco Excise Taxes

Higher taxes induce quitting, they prevent relapse, reduce consumption and prevent the young and/or new smokers from acquiring the habit. Estimates indicate that a 10% rise in price reduces overall smoking by about 4%.<sup>95</sup> About half of the impact of price increases is on smoking prevalence. Estimates for young adult smokers indicate that 10% price rise would raise the probability of an individual quitting smoking by over 3%.<sup>96</sup> It has further been estimated that young smokers are two to three times more sensitive to increases in price than older adults.<sup>97</sup>

Evidence from developed countries clearly shows that an increment in the price of cigarettes has the greatest impact on smoking amongst people with the lowest income and least education. In the U.S., for example, estimates indicate that smoking in households below median income level is about 70% more responsive to price than those above median income level. Young people are more responsive to an increase in price and this could be attributed to a number of factors including lower income, peer influences and shorter smoking histories.

Tobacco taxes have been accused of having many negative impacts but these can be demystified as follows;

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<sup>95</sup> van Baal PH, Brouwer WB & Hoogenveen RT et al (2006). Increasing tobacco taxes: A cheap tool to increase public health. *Health Policy* published online Oct 2006, viewed on 19<sup>th</sup> June 2009 .

<sup>96</sup> The World Bank (1999) *Curbing the epidemic: governments and the economics of tobacco control*. Washington DC: The World Bank.

<sup>97</sup> Oglivie D, Gruer L & Haw S (2005) Young People's Access to Tobacco, Alcohol, And Other Drugs. *British Medical Journal* p331

### 4.3.1 Higher Tobacco Taxes and the Poor

The primary concern over tax equity is whether cigarette and other tobacco taxes are regressive—that is, whether the tax accounts for a higher percentage of the income of poor versus wealthy individuals.

A basic principle of tax policy suggests that individuals with the greatest ability to pay should be taxed more heavily (“vertical equity”). Cigarette and other tobacco taxes can appear to violate this principle. If everyone uses the same amount of tobacco products, then:

1. All groups pay the same *absolute* amount of tobacco taxes.
2. Taxes account for a higher *proportion* of the income of poor people.
3. Taxes are *regressive* with respect to income.

If poor people use *more* tobacco products than wealthy people, then the tax is more regressive on the group of poor individuals. However, even if cigarette taxes fall most heavily on poor smokers, increases in tobacco taxes can be progressive provided lower income smokers significantly reduce their smoking. The implication is that the poor are more sensitive to price increases than the wealthy, and will therefore reduce consumption based on the degree of the overall price due to a tax increase. A beneficial result is an increase in the quality of their health and economic welfare.



Therefore, in the short run, the poor face a heavy burden, but in the long run the benefits far outweigh the costs. This implication is proving true, as there is growing evidence in a number of countries that people with lower incomes reduce tobacco consumption more than higher income groups when overall prices rise.

This tax is clearly regressive. However, a *tax increase* is not regressive because the increase in the tax paid by the low-income smoker is less compared to the increase for the high-income smoker. So although the starting tax is regressive, the tobacco tax increase is progressive and the overall regressiveness of the tobacco tax is therefore reduced.

### **4.3.2 Smokers and the Cost of Their Habit**

Tobacco taxes can help “internalize” costs which smokers impose on themselves and society. Taxes can be used to improve economic efficiency where there are externalities. If tobacco excise taxes are viewed as a way to “internalize” the social costs of smoking—that is, to add an element of the social implications of smoking to the price that smokers must pay—one could measure this social cost and set the tax rates accordingly. Thus, set the amount of tax on cigarettes so that total tax revenue paid for by smokers equals the total social cost generated by smokers.<sup>98</sup>

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<sup>98</sup> Supra footnote 82

In general, these externalities fall into two categories: the financial externalities associated with the impact of tobacco use on the costs of healthcare, group health and life insurance, pensions, and other collectively financed programs; and the costs associated with the health and other consequences of exposure to environmental tobacco smoke.

### **4.3.3 Smuggling**

The potential for smuggling tobacco can limit increases in tobacco tax rates. When setting tax rates, it is important to consider the risk of smuggling, the purchasing power of local consumers, tax rates in neighbouring markets, and the ability and effectiveness of the tax authority to enforce compliance.

However, those who oppose tobacco tax increases often exaggerate the amount and risks of smuggling. For example, in South Africa the tobacco industry predicted massive smuggling when the government announced a series of large increases in tobacco taxes. Although smuggling did increase, it did not occur on the massive scale suggested by the tobacco industry.

### 4.3.4 Deterrence

While there is some debate about whether the tax is borne fully by consumers or whether the individual firms bear a part of the tax, there is no dispute that an increase in excise tax raises the retail price of tobacco products.

Research shows that an excise-induced real price increase should reduce consumption in both developed and developing countries, but that the impact is likely to be larger in developing countries. Given the relatively low levels of income in developing countries, smokers in developing countries are likely to be more sensitive to changes in the price of tobacco products than smokers in developed countries.

Studies performed in developed countries indicated that the youth and poorer people are more sensitive to price changes than other population groups.<sup>99</sup> If the same principles hold true in the developing countries, excise rate increases will serve, firstly, to reduce the take-up of smoking amongst the youth and, secondly, to discourage smoking in those groups (mainly the poor) that are not easily reached by alternative tobacco control measures, such as education campaigns.

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<sup>99</sup> *Supra* note 57

An important issue concerns the substitutability of tobacco products. If the government increases the excise rate on cigarettes, but not on other tobacco products, the extent to which the excise tax is passed on to consumers depends on the industry structure. There will be an incentive for smokers to switch to the lower-priced alternatives. Thus, if taxation is to be effective in reducing consumption, alternative tobacco products have to be taxed equivalently.

### **4.3.5 Government Revenue**

The government's agenda is largely driven by a need to collect revenue in order to meet obligations. Consequently, many governments fear that the imposition of higher taxes will result in lower revenues because of a drop in the number of smokers. This fear is unfounded because the increase in excise tax will be felt most by teenagers and the poor who do not have money to spare. A change in excise will not be felt immediately but will only be realised after a gradual drop in the number of new persons becoming addicted.

The drop in the number of smokers will in the long run result in a cumulative increase in savings made from reduced spending on health issues. This will mainly be because of the drop in the number of people falling ill from smoking related ailments.

By focusing on health issues when imposing tax, governments are able to demonstrate their interest in promoting good health. By raising revenue only, governments demonstrate their short-sighted interest in meeting their budgetary interests only.

## 4.4 Recommendations

It is important that matters of health should not be overlooked even as governments seek to meet their revenue targets. It is therefore necessary that research should be carried out into the impact of tobacco use on health and emerging trends in this area with a view to linking this with increments in excise tax.

Taxation on all tobacco products should be standardised and increased at higher than inflation rates to reduce the affordability and therefore availability of cigarettes. There are strong public health arguments for retaining high levels of tobacco taxation, despite concerns that tobacco taxes may be regressive because they are disproportionately paid by the people with low income backgrounds. The evidence shows that, because the least affluent smokers are more likely to quit in response to price increases, the tax increase is borne more heavily by those who are most able to afford it.<sup>100</sup> The World Bank has thus concluded that tobacco tax increases are not regressive.<sup>101</sup>

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<sup>100</sup> Townsend J, Roderick P & Cooper J (1994) Cigarette smoking by socioeconomic group, sex and age: effects of price, income and health publicity. *British Medical Journal* p309.

<sup>101</sup> The World Bank (1999) *Curbing the epidemic: governments and the economics of tobacco control*. Washington DC: The World Bank.

It is therefore important to implement a cycle through which:

1. increased tobacco taxes raise cigarette prices which, given the limited income of the youth, makes cigarettes more expensive to purchase, leading to
2. an increase in the mean age at which an individual starts smoking, which in turn leads to
3. a lower total consumption of tobacco, which leads to
4. lower future health care costs, deaths and diseases.

If the duty rate is harmonised in regional organisations like at the EU and East African level, it should be a levelling-up process. No country should be required to reduce its duty level and a health impact assessment of any change in duty levels should be carried out.

Countries should be encouraged to adequately fund and resource smoking cessation services. In addition to money already provided, a percentage of the money collected like two per cent of the revenues raised from tobacco tax should be ring-fenced for use in providing cessation services especially in areas of deprivation.

Countries should also take action to combat the illicit trade in tobacco in order to prevent smokers from evading high tax rates through illegal means. This includes reducing the amount of cigarettes allowed for personal use when travelling between countries.

Standardised surveys on the prevalence of tobacco use in general populations should be carried out in sub-Saharan Africa. Periodic surveys are necessary to show trends, define useful indices for focusing prevention measures and provide benchmarks against which the impact of tobacco control activities can be measured.

Lobby groups and the civil society should put pressure on the government to increase excise tax in line with increments in earnings in society. Other measures for tobacco control should also be put in place to ensure that the negative effects of smoking are contained. The civil society and Non-Governmental Organisations should also play a major role in ensuring that the necessary data is available through carrying out adequate research.

In instances where a government is reluctant to use excise tax to regulate behaviour then the World Health Organisation (WHO) should find avenues for compelling them to comply with the requirements of the Framework Convention on Tobacco Control.

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