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Sin Taxes

Following the second Legislative Executive Development Advisory Council meeting, sin-tax reform has been added to the government's priority legislation. It is hard to overemphasize the importance of a meaningful reform of alcohol and tobacco taxation.

As a background, the revenue yield from sin taxes has declined by 37 percent since 1997 and now yields just 0.7 percent of GDP. This low revenue yield and erosion mainly reflects four factors. First, the attrition of the real value of excise rates, as the specific rates have not been adjusted sufficiently in line with inflation. Second, the use of 1996 retail prices to determine the tax rate for older brands. Third, low excise tax rates, with the average excise to retail sales price as low as 25 percent for low-tier brands. And fourth, substitution from mid- to high-priced brands to lower priced brands. The issues with alcohol taxation are broadly similar, characterized by low excise rates, non-indexation, and the use of outdated reference prices.

As a result, tobacco tax rates as a percent of the price in the Philippines are among the lowest in South East Asia, well below those in Indonesia, Vietnam, and Thailand. Likewise, prices for cigarettes are among the lowest for low to middle income countries. A major downside of this policy stance is that the country has become the largest consumer of cigarettes among ASEAN countries (and 15th worldwide), where almost one-fifth of Filipinos begin smoking before the age of 10 and prevalence is increasing.

A meaningful sin-tax reform should achieve four objectives. First, there should be a shift to a uniform excise tax rate for all cigarette brands and for each class of alcohol. The current four-tier classification system for tobacco distorts production and promotes consumption of cigarettes by low income earners. Second, excises on alcohol and cigarettes should remain specific (including for cigars) rather ad-valorem. To be precise, the choice between specific versus ad-valorem excises is not necessarily straightforward as each has its pros and cons. Ad-valorem taxes encourage competition (as the effect of lowering the price will be amplified by lower taxation), are progressive (higher priced brands would be taxed more), would make it harder for producers to shift the tax burden to consumers in an oligopolistic market structure, and would not require indexation to inflation. As a con, sin-tax revenue would be more volatile under an ad-valorem system.

Specific levies (per unit of pack) reduce relative price differences between cheap and expensive cigarettes. In contrast, ad-valorem rates increase absolute price differences. If the primary purpose is to discourage smoking and drinking, a strong case can be made for specific excises—the same tax burden per cigarette or per unit of alcohol.

Despite these pros and cons of each type of taxation, there is one overwhelming reason to favor specific rates over ad-valorem rates: it reduces opportunities for transfer pricing. Transfer pricing refers to “creative” invoicing to effectively shift profits from one entity to a related entity for the purpose of exploiting differences in tax treatment. This is easier under ad-valorem taxes as tax administrations, including those in advanced countries, struggle with determining the real value of products (rather than simply counting quantities) and perhaps explains why the vast majority of countries in the Asia and Pacific region levy specific taxes. As an aside, transfer pricing is also a serious concern if a country provides tax incentives as firms will try to shift profits into affiliated companies that enjoy an income tax holiday.

Third, given the preference for specific rates, a sin-tax reform should include a provision to automatically and fully index the alcohol and cigarette excises to inflation. Fourth, the excise rate should be increased markedly to recover the distortions in the past and achieve the desired health benefits given the low elasticity of demand. To put the tax in line with international standards, tax rates should achieve at least an average excise to retail sales price ratio of 50 percent. Indeed, slapping high tax rates on monopolies (as is the case with the tobacco sector in the Philippines) is generally a first-best response to transfer some of the excess profits earned back to the users (likewise for taxes on oil given the presence of OPEC). To be effective, the reform requires further improvements in administrative efforts and the adoption of cigarette stamps to minimize leakages from smuggling due to the proposed higher tax regime.

Some observers object to such a sin-tax reform citing its perceived negative impact on employment. There are several considerations here, however. First, excises are among the least distortionary forms of taxation and not the main determinant of employment in the tobacco industry. Technological developments are more important for competitiveness. This is evidenced, for example, by the fact that employment in tobacco dependent sectors has been declining around the world due to more capital-intensive production methods. Second, the money not spent by users who quit or spend less on tobacco and alcohol products after a tax increase will not disappear from the economy, but will instead be spent on other goods and services, creating jobs in these sectors, with the net impact generally positive. For example, if the incremental government resources would be used for universal health care, jobs will be created in this more labor-intensive sector. Third, sin-tax reform would increase the tax effort and therefore boost investor confidence (the weak tax effort being the main ratings’ constraint) leading to further job creation. Finally, any adverse impact on tobacco-sector employment would occur gradually, providing time to implement crop-diversification and retraining programs, which were undertaken for example in Indonesia and Turkey.

One way to get a sense of the overall employment impact would be to compare excise multipliers with those of government expenditure. The former is smaller than the latter, implying that additional health care spending funded through sin-tax reform would increase output and therefore employment. All in all, a reform as contemplated above would be a big step forward, enabling higher, healthier, and more inclusive economic growth.

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