Tobacco excise duties in countries of the Gulf Cooperation Council

World Health Organization
REGIONAL OFFICE FOR THE Eastern Mediterranean

Suggested citation. Tobacco excise duties in countries of the Gulf Cooperation Council. Cairo: WHO Regional Office for the Eastern Mediterranean; 2016. Licence: CC BY-NC-SA 3.0 IGO.

Contents

Acknowledgment

WHO acknowledges the contributions of Sofia Delipalla, Professor, School of Economics and Regional Studies, University of Macedonia, who prepared the report and Frank J. Chaloupka, Distinguished Professor of Economics and Public Health and Director of the Health Policy Center, University of Illinois, Chicago who wrote the introduction and reviewed the report.

Introduction: the time is right for an excise tax on tobacco products in GCC countries

Gulf Cooperation Council (GCC) countries are at an important crossroads when it comes to fiscal policy and health. Traditional sources of government revenues are falling and becoming increasingly unreliable given the volatility of the world's oil and gas markets and as a result of bilateral, regional and global trade agreements that are reducing import duties. At the same time, growing populations and increasing development are leading to increased spending. As a result, government budgets are increasingly under pressure and new sources of revenues are needed.

At the same time, the prevalence of tobacco use is rising, which will place further strains on government budgets in the future, given the increasing costs of treating the diseases caused by tobacco use and the rising productivity losses resulting from the death and disease caused by tobacco use. For example, the World Health Organization (WHO) predicts that, from 2015 to 2025, smoking prevalence will rise from 15.1% to 22.7% in Oman, 18.5% to 23.8% in Saudi Arabia, and 34.4% to 59.9% in Bahrain.

In contrast to nearly all other countries around the world, GCC countries do not levy excise taxes on tobacco products, but instead rely on import duties for revenues from tobacco. Given trade agreements, import duties are low and falling, which has led to relatively low prices for cigarettes and other tobacco products in GCC countries. Moreover, given relatively high incomes, cigarettes in GCC countries are among the most affordable in the world.

Imposing significant new excise taxes on tobacco products should be an important part of the solution to these problems and would be a 'win-win' for the region.

First, implementing sizable excise taxes on tobacco products would produce a public health win. Prices for tobacco products would rise, leading to significant reductions in tobacco use, as these higher prices would lead many current tobacco users to quit, deter former users from restarting, prevent young people from taking up tobacco use, and lead to reductions in consumption among continuing users. The impact of the higher taxes and prices would be greatest among the most vulnerable populations – the poor and the young – who are particularly price sensitive. These declines in tobacco use would lead to reductions in the death and disease caused by tobacco use.

Second, the implementation of new high excise taxes on tobacco products would generate significant new tax revenues, a win for government budgets. Replacing the current import duties that account for just over 40% of the price of the most popular cigarette brand with an excise tax that reached the WHO recommended level of 70% of price would more than double the revenues GCC countries currently receive from tobacco, while at the same time reduce tobacco use by nearly 40%.

Third, adopting significant new excise taxes on tobacco products would improve productivity and create new jobs, a win for GCC economies. Given that nearly all tobacco and tobacco products are imported, most of the profits from the distribution and sale of tobacco products are flowing out of the Region to multinational tobacco companies. At the same time, the workforce is less productive given time lost due to diseases and premature deaths among tobacco users. Productivity would increase as tobacco use falls, while the money former tobacco users once spent on tobacco products would be spent on other goods and services, creating new jobs, and government spending of new tax revenues would create even more new job opportunities.

Finally, using some of the new revenues from tobacco excise taxes to fund tobacco prevention and cessation programmes and other health promotion efforts enhances public support for these taxes, a political win. Surveys from both GCC countries and from countries around the world demonstrate strong public support for tobacco taxes, particularly when the revenues are used in efforts to further reduce tobacco use and promote health. Even a majority of tobacco users will support tobacco tax increases when revenues go to preventing young people from taking up tobacco use and helping current users break their addiction.

The Guidelines for the implementation of Article 6 of the WHO Framework Convention on Tobacco Control (FCTC) and the WHO Technical manual on tobacco tax administration provide useful guidance on how to best implement tobacco taxes, based on the experiences from countries around the world. Particularly important best practices include: levying a uniform specific excise tax (a tax based on quantity); imposing similar taxes on all tobacco products in order to minimize substitution among products and to maximize the public health and revenue impact of the taxes; and regularly increasing specific taxes in order to reduce the affordability of tobacco products over time. Both documents highlight the importance of effective tax administration, including the use of state-of-the-art technologies such as encrypted tax stamps and tracking-and-tracing systems, strong enforcement, and swift and severe penalties on those engaged in illicit tobacco trade. Following these and related best practices will maximize the health, revenue, and economic impact of tobacco excise taxes.

This report provides a clear roadmap for GCC countries to follow moving forward, given the global evidence on the effectiveness of tobacco taxes in promoting health and raising revenues, and based on the best practices in tobacco taxation gleaned from experiences in numerous countries around the world. The time is right for GCC countries to adopt significant excise taxes on tobacco products.

Executive summary

Globally, increased oil supply from unconventional sources and rising energy efficiency puts downward pressure on oil prices. In addition, fluctuating expectations of global demand and geopolitical risks lead to oil price volatility. At domestic level, in spite their strong economic performance, the Gulf Cooperation Council (GCC) countries face large increases in government spending and rising fiscal vulnerabilities. As domestic energy consumption increases, export volumes will decline. Moreover, an increasing number of bilateral and regional agreements imply a reduction in customs duties. Together, these factors imply a growing need for revenues among GCC countries. Increases in excise taxes are one option for generating these increased revenues. In the case of harmful products, such as cigarettes and other tobacco products, taxation is not simply a revenue raising device but also a public health policy. A large number of potential users, combined with relatively weak tobacco control measures, including very low taxation, make GCC countries a fertile ground for tobacco multinationals.

GCC countries are among very few countries in the world that do not apply excise taxes on tobacco products, relying instead on import duties, given that virtually all tobacco products are imported. Given the low import duties, prices for tobacco products in GCC countries are well below price averages in the Region as well as in countries that are comparable with respect to income level. These low prices contribute to higher tobacco consumption and to increases in the death, disease, and economic costs caused by tobacco use. GCC governments need to act quickly and in a coordinated manner to protect both their budgets and public health.

This report recommends:

1. Apply excise taxes on all tobacco products

   Apply excise taxes on all tobacco products, both to protect GCC citizens from the harms of tobacco use and to offset revenue lost due to falling import duties resulting from an increasing number of bilateral and regional trade agreements.

   - The tax rate is recommended to be higher than the current import duty rate, if it is to be an effective instrument for both generating new revenues and reducing tobacco use.
2. Design the right excise tax system
   - A uniform specific excise tax (i.e. based on quantity) is simple and effective in reducing consumption of tobacco products. The World Health Organization (WHO) recommends that the excise tax level should be at least 70% of the final retail price.
   - Tax all tobacco products comparably, in order to minimize opportunities for substitution.
   - Adjust tax rates regularly, for inflation and income increases, so that tobacco products do not become more affordable over time and with economic growth.
3. Administer and implement the tax effectively
   - Build the institutional infrastructure to support changes in tax rates, tax administration and tax structure.
   - Provide tax training to administrative staff.
   - Adopt new technologies to monitor and enforce tax collection.
   - Set high licence fees for the sale of tobacco products.
   - Set swift and severe penalties for those engaging in illegal activities related to tobacco tax avoidance and evasion.
4. Collect the necessary data

   Collect the necessary data in a reliable manner and regularly.

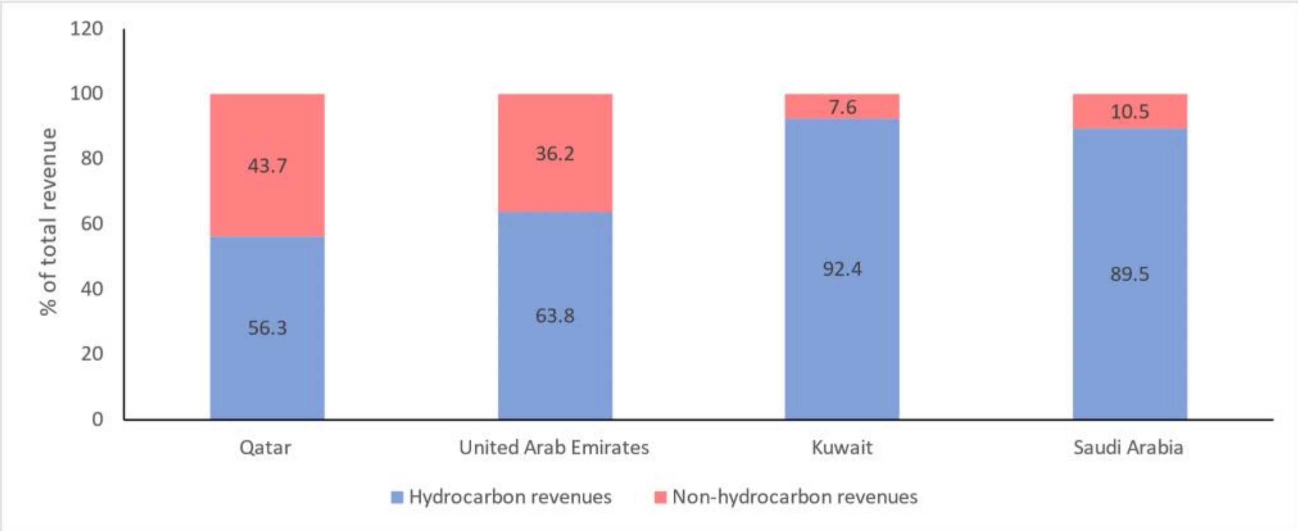
   - Collect data on: (a) domestic market structure (number of firms and their respective market shares); (b) firms' strategic pricing; (c) consumers' responsiveness to tax and price changes as well as income

changes; and (d) consumers' substitution among tobacco products in response to changes in relative prices and income.
  - Convert them into information to make the right choices, given the economic, administrative and social realities.
5. Facilitate and enhance international coordination
  - Implement any tax policy change, both in tax design and tax administration, in coordination with other GCC countries to eliminate cross border shopping and bootlegging, and safeguard revenues.
  - It is recommended that any policy change, both in tax design and tax administration, is guided by the WHO international treaties and protocols on tobacco products.

1. GCC economies: some facts

The main source of government income in all Gulf Cooperation Council (GCC) economies is oil and gas production. In 2013, in most GCC countries, hydrocarbon revenues account for about 60% of total revenues. For Saudi Arabia and Kuwait, this is 90% and 93% respectively. Apart from Qatar and the United Arab Emirates, the contribution of non-oil government revenue is very low in GCC countries. Figure 1, below, shows the share of hydrocarbon revenues to total government revenues for the four leading GCC economies, based on their Gross Domestic Product (GDP) contribution to the entire economy. Hydrocarbon revenues are the main, and in some cases almost the only, source of government revenue. In Norway, an economy that is also rich in resources, oil revenue accounts for just about 30% of government revenues [2].

Figure 1. Share of hydrocarbon revenues to total government revenues, 2013



Source: [2].

For GCC countries, given the use of the United States dollar peg as an external anchor for monetary policy, spending of hydrocarbon revenues is the main instrument for economic policy. The high dependence on hydrocarbon revenues, however, makes GCC fiscal policy vulnerable to oil price volatility. Although the countries can survive any short to medium term price shock, a persistent reduction in oil prices could turn fiscal surpluses into deficits, for some countries sooner than others. The International Monetary Fund (IMF) expects overall GCC fiscal balance to turn into deficit towards the end of the current decade [3]. Oil and gas market demand and supply conditions are changing, and these changes are outside the control of GCC countries. Recently, increase in non-conventional oil production from the United States as well as weak global oil demand put downward pressure on oil prices. Moreover, whilst oil prices are declining, fiscal break-even levels for oil prices are rising due to increased government spending. GCC economies are affected by what is happening in the global economy, and governments in the Region need to find new sources to fund public spending.

The contribution of the non-hydrocarbon sector to GDP has grown considerably over the last couple of decades, but it is still revenue from hydrocarbon exports that determines public spending in GCC countries. Saudi Arabia, the largest crude oil exporter, counts on the non-hydrocarbon sector to be a key driver for future growth. The main sources of non-oil revenue are fees and charges for public services and customs tariffs. However, non-hydrocarbon revenues have not increased much over the last few years, indicating that Saudi Arabia did not implement changes sufficient to offset declining hydrocarbon revenues. Kuwait's economy is much more concentrated in hydrocarbon production and it is completely dependent on oil revenues. As it is vital for the country to find alternative sources of income, IMF suggested long ago that Kuwait extend the 15% corporate tax imposed on companies owned completely by foreign investors to all firms, and to impose a value-added tax (VAT) across all GCC countries. Qatar has made a greater progress, in relation to other GCC countries, in terms of increasing revenue from the non-hydrocarbon sector. Qatar's government has a long-term objective to finance its entire budget activities through non-hydrocarbon revenues by 2020. Similarly, the Emirate of Abu Dhabi has a long-term target to reduce dependence on oil to 36% by 2030 [4].

Because of their large revenues from hydrocarbons, GCC countries are not under immediate pressure to tax domestic economic activities in order to finance public spending. Governments simply allocate hydrocarbon revenue to society. To attract foreign investment, governments rely on a zero or low tax environment. This, however, means that society is not based on an efficient economic foundation. Hydrocarbon revenues are the main source of wealth, and this source is finite and unstable. Economic diversification has been on the political agenda for some time now. Over the years, there has been a lot of speculation that GCC countries will introduce a VAT or excises, but these have yet to happen.

2. Definition of excise duties

Excise taxes are a type of indirect taxation. Indirect taxes are levied on transactions and not directly on persons or companies. The most common type of indirect taxation is a general sales tax (GST) or a value-added tax (VAT), which is a tax on consumer spending. VAT is generally a broad based tax, applied at each stage of the production process, and its main objective is to raise revenue without distorting consumer choices at the margin. Excises, on the other hand, are imposed on the consumption of certain goods, whether domestically produced or imported, for reasons discussed in some detail in section 3 below. Excises are not imposed instead of VAT but normally in addition to it; that is, they form part of the VAT tax base. As a consequence, an increase in excise tax rates implies an increase in both excise and VAT revenue levels.

Excises are usually assessed by reference to weight, volume, strength or quantity of the product, in some cases combined with the value, or they are assessed by reference to the value alone [5]. So, excises can take two general forms: they can be a tax per unit (specific tax) or a percentage of the value of the product (ad valorem tax). In general, excises do not become payable until products enter free circulation and are typically collected early in the distribution chain. They are easy to collect as, usually, there is a small number of taxpayers at the manufacturing or wholesale stage. Excise tax systems differ across countries in terms of the products taxed, the tax structure, the tax rate, and the stage of taxation.

3. Objectives of tobacco excises

Most countries levy excise taxes on goods such as tobacco products, alcoholic beverages, and petroleum products. In the past, the primary objective of such taxation was to raise revenue. Goods like the ones mentioned above face relatively price inelastic demand; that is, their consumption is not very sensitive to price changes. As a result, taxing such goods produces a relatively stable source of revenue at a low cost to society; that is, the inelastic demand implies a small efficiency loss from taxation as distortions on society's choices (e.g. consumption patterns) are small. Moreover, the tax is politically acceptable as these goods are seen as "sin goods". Their consumption harms either the persons consuming them or/and their environment and generate additional costs (externalities) that are not borne by the producer or consumer.

For tobacco products, due to their addictive nature, demand is relatively insensitive to price changes. It is estimated that in high income countries, the overall price elasticity of demand is -0.4 (a price increase of 10 per cent reduces overall consumption by 4%). In low- and middle-income countries, the estimated price elasticity is -0.5, on average. Elasticity estimates, however, vary with socioeconomic and demographic factors. Young consumers, for example, are more responsive to price increases, two to three times the estimates for adults (most estimates lie between -0.5 and -1.2 in high-income countries). Moreover, there is evidence that responsiveness to price increases is higher among the poor than the rich in high-income countries.[1] In general,

[1] This is less evident in other countries maybe due to the extent of opportunities for tax avoidance and evasion.

the evidence shows that countries which increase excise taxes on tobacco products see their revenues increase, certainly in the short- to medium-term [6].

In recent years, excise taxes have been increasingly used as corrective taxes. They are imposed, for example, on goods whose consumption creates a negative externality to society. Consumption of goods like tobacco products imposes a negative external cost to society, due to the health consequences of exposure to tobacco smoke among non-smokers. There is a gap between private and social cost of smoking: this is the direct cost smokers impose on non-smokers. Even if we could at least partially correct for this distortion in the market by banning smoking in public places, an externality may still exist due to the resource costs borne by society. These resource costs are due to the medical treatment of smoking-related diseases, when this cost is publicly funded, or due to lost productivity from tobacco related diseases and deaths. A corrective tax is imposed to internalize this external cost which is not accounted for by the price mechanism [7].

Excises can also be used to correct what has been identified in the literature as an internality: a cost that consumers impose on themselves. Consumption of tobacco products, for example, harms the person that consumes the product. Nearly all users of tobacco products begin when they are young and cannot appreciate fully the consequences of addictive behaviour and do not estimate correctly the full cost of their decision today. Their present consumption creates an externality to their future selves (see, e.g. [8], [9]). An excise tax can be imposed to reflect this cost and to discourage consumption of the harmful product. It is difficult, however, to measure the internal and external costs, which are likely to vary across different groups in society.

Tobacco taxes, apart from being an efficient way to raise revenues, are the most cost-effective tobacco control policy for reducing tobacco use [6]. Higher prices due to taxation reduce the prevalence of tobacco use by discouraging non-users from taking up tobacco use, encouraging existing users to quit or reduce consumption, helping former users to stay off tobacco, and preventing occasional smokers from becoming regular smokers.

Given this, many governments now use excise taxation to achieve both health and revenue objectives. When these taxes are levied primarily for public health purposes, many governments earmark some of the revenues for other activities that further discourage consumption of the taxed products. Earmarking also builds political support for imposing such taxes and for increasing tax rates.

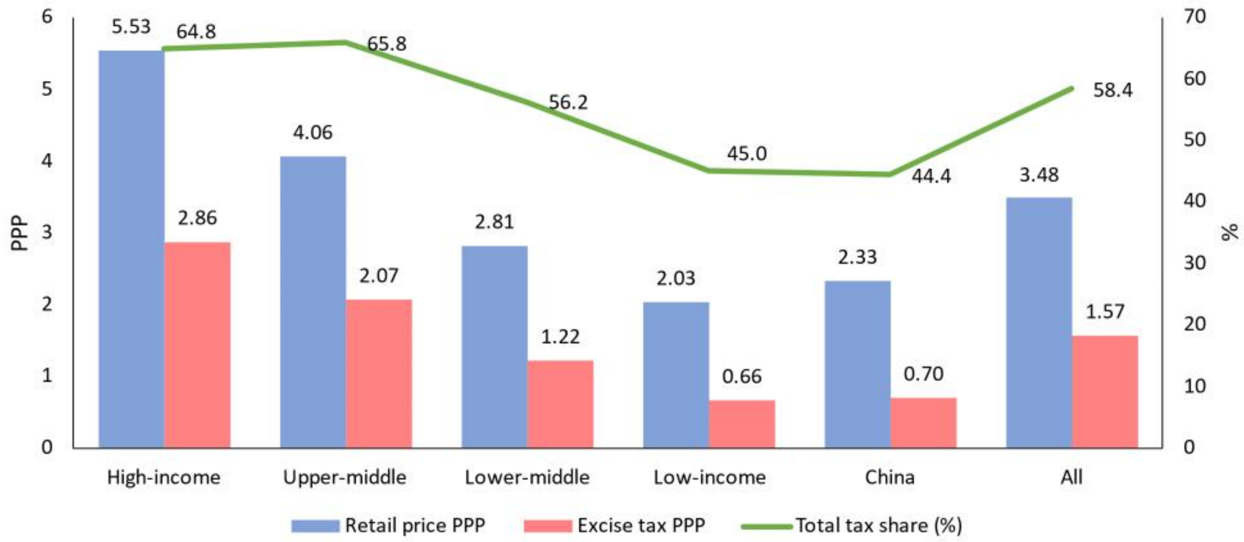
4. Tobacco taxes and prices: trends and rates worldwide

Among the 187 countries, for which data are available, 61 countries apply specific excises on cigarettes, 46 countries apply ad valorem, 61 countries have a mixed system that applies both specific and ad valorem taxes, and 18 countries have no excise taxes [1]. The rate of taxation can be uniform or differentiated (tiered) based on different product characteristics (e.g. length of cigarette, volume of production, packaging characteristics, etc.) or different tax base (e.g. consumer or producer price level). Worldwide, 20 countries apply tiered specific excises on cigarettes, six countries apply tiered ad valorem excises, and seven countries apply a tiered mixed system [1].

With respect to other tobacco products, various approaches are used. In the United States, for example, all states apply uniform specific taxes on cigarettes, but most states apply ad valorem taxes on other tobacco products. Moreover, the excise taxes on these products typically account for a much lower share of retail prices than cigarette taxes. In India, for example, manufactured bidis are taxed at a rate of 26 rupees per 1000 sticks, while handmade bidis are taxed at 14 rupees per 1000 sticks, well below the lowest cigarette excise tax of 669 rupees per 1000 sticks [10]. In the European Union, a mixed system of excise taxes is levied on cigarettes with a minimum excise tax per 1000 cigarettes. Regulation on the types of taxes for other tobacco products, however, is not as restrictive as cigarette taxation. As a result, there is a great difference in taxation rates between cigarettes and roll-your-own tobacco in a number of European Union countries (e.g. Denmark, Germany, Netherlands or the United Kingdom), which has led to increased substitution towards roll-your-own over the past decade [11].

According to the WHO Report on the global tobacco epidemic database [1], the average share of all taxes in retail price globally (weighted by estimated number of smokers in each country and based on the price of the most popular cigarette brand) is 58.4%, while excise taxes amount to 45.1% of price. This is far below the WHO recommendation that excise taxes account for 70% of final retail price. Figure 2, below, shows considerable variation in prices and excise tax shares across countries based on income level. The global average price of a pack of 20 cigarettes of the most sold brand in each country, as of July 2014 is PPP $3.48. Taxes, prices, and taxes as a share of price are highest in high-income countries, and fall as income levels fall.

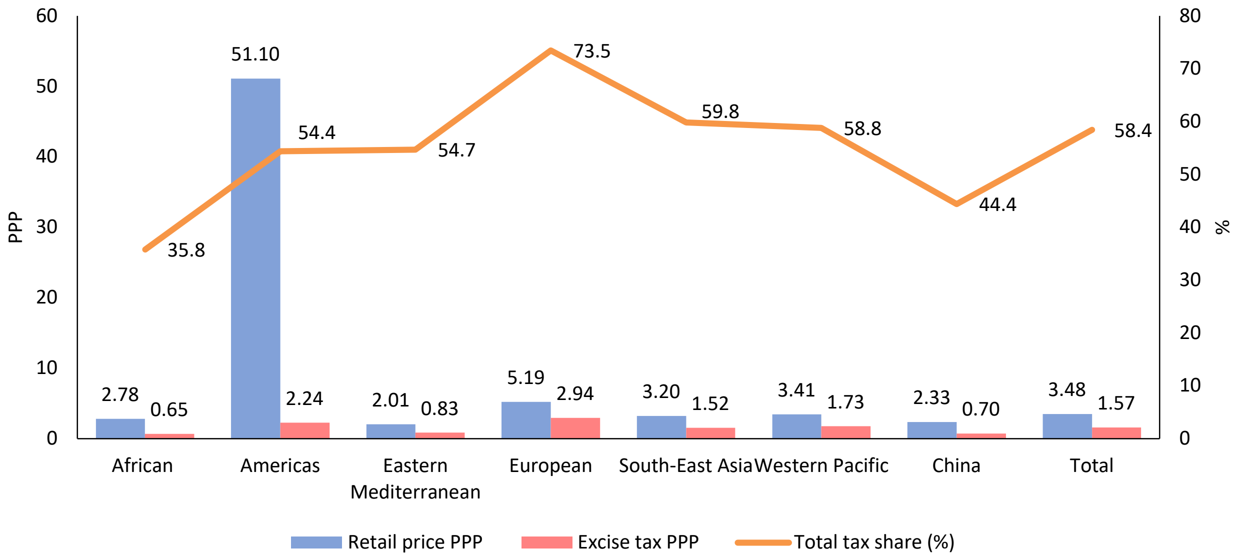
Figure 2. Average retail price, excise tax per pack and total tax share, by income group, 2014



Source: [1].

By region, as shown in Figure 3, the average price and excise tax share are highest in the European Region (EUR) and lowest in the Western Pacific Region (WPR). In the Eastern Mediterranean Region (EMR), the regional average price (PPP $ 2.01) is well below the global average; the average excise tax share (41.3%) and total tax share (54.7%) are also below the global average. According to the WHO Report on the global tobacco epidemic database [1], a number of countries in the Region, including GCC countries, do not impose any excise tax on cigarettes.

Figure 3. Average retail price, excise tax per pack and total tax share, by WHO Region, 2014



Source: [1].

5. Design and implementation of tobacco taxation

As we saw in the previous section, almost all countries levy excise taxes, in addition to VAT, on cigarettes. GCC countries are among the very few exceptions that impose no consumption taxes on tobacco products [1]. Instead, GCC countries levy only an import duty, at 100% of declared CIF (cost, insurance and freight) value or a minimum specific duty based on quantity. However, regional and global trade agreements constrain GCC tariff policy, as described below in section 6, and GCC governments need to turn to: (i) other sources of revenue; and (ii) other price mechanisms to combat tobacco consumption or pursue public health policy in general. Excise taxation, on top of a VAT, is such a mechanism. Relying on excise taxation, and not import duties, for tobacco products is one of the recommendations of WHO [6] and the Guidelines for the implementation of Article 6 of the WHO Framework Convention on Tobacco Control on price and tax policies [12].

When it comes to the design of an excise tax system, the first question is which type of excise tax to adopt. Why do some countries choose specific and other ad valorem taxation on cigarettes? Why do some levy a combination of the two types? Economic theory suggests that the best tool depends on the primary objective of the tax. If tobacco taxation is used so that it internalizes, to at least some extent, the negative externalities caused by smoking, or if it is used to discourage consumption by raising price, then quantity and not price is the appropriate tax base, implying that a uniform specific tax is the right tax. Theory shows that, in markets where firms have some degree of market power, specific excises lead to a relatively higher consumer price than ad valorem taxation, for a given level of tax revenue (see [6] and references therein). Theory also shows, however, that specific excises increase market power and profitability in the industry. This is consistent with the multinational tobacco industry’s preference and lobbying for specific taxation [13]. If concerns about market dominance are important, in markets with monopoly power and little product differentiation, ad valorem taxation is a more attractive option. This, however, would lead to relatively lower prices, something that is not consistent with the corrective purpose of tobacco taxes.

Producers of cigarettes respond differently to specific and ad valorem taxes. Specific taxation is based on number of units independent of value, so producers have an incentive to increase the value per unit (increase size of cigarettes or perceived “quality”) to minimize tax liability. Specific taxes favour expensive products over cheap ones, distorting producers’ decision about brand “quality” and packaging. Ad valorem taxes, on the other hand, tend to discourage costly improvement in product specifications due to a ‘multiplier effect’ (a change in producer price increasing the tax and causing a larger change on consumer price).

Governments choose the type of tax based on their objectives, as well as economic and political conditions. The European Union, for example, chose a combination of the two types of taxes, initially as a compromise to the different objectives (public health not being one of them at the time) and local conditions of European Union Member States. Member States with a low production cost favoured ad valorem taxation, whereas Member States with a high production cost favoured specific taxation. A mixed tax was a compromise, and acted as a means of achieving neutrality between Member States with different levels of production costs [5]. However, as the public health objective became more prominent over the recent years, the European Union has increasingly moved towards specific taxation.

Theory abstracts from many practicalities that governments face related to each type of tax. Specific excises are more easily administered when value is difficult to determine. A company could understate the wholesale value of the product, if its tax liability is assessed on an ad valorem basis. An importer has an incentive to undervalue the imported product, when import tariffs are ad valorem. It is generally easier to measure quantity than value, which makes a specific tax preferable. One of the disadvantages of specific excises is that they do not rise with inflation and lose their real value if not adjusted as overall prices change. This is easily dealt with, though, as governments can adjust the tax regularly with inflation.

Answers to the questions “which is the right tax type?” and “which is the right tax rate?” are not simple. Each government, when designing the tax structure and determining the tax level, given its objectives, must take into account the peculiarities of the local economy, the market conditions, and its starting point. The WHO recommendations, however, which are based on best practices around the world, can serve as a road map. As far as the choice of level and type of cigarette taxation is concerned, WHO recommends an excise tax level of at least 70% of the retail price and reliance on uniform specific excise, unless country specific circumstances dictate otherwise. For example, European Union Member States are constrained by the Single market framework. Although the tobacco directives do not set actual duty rates, they prescribe the type of tax (both specific and ad valorem), the minimum level of tax (at least EUR 90 per 1000 sticks and at least 60% of the weight average retail price, including VAT), and the range of tax rates (specific component should not be less than 7.5% and no more than 76.5% of total tax) [14]. Moreover, governments should adopt comparable taxes and rates on all tobacco products [6]. Governments with distributional concerns might prefer ad valorem taxation to preserve the low-price variants of the tobacco products. This is not the right approach since there are more appropriate instruments, such as a progressive income tax system, to deal with distributional concerns directly. Further, setting differing tax rates for different variants of tobacco products does not help low-income groups; on the contrary, it increases health inequities. Moreover, it introduces administrative complexity, unintended inefficiencies, and scope for lobbying by the tobacco industry.

Once a tax is (well) designed, administration issues arise. The administering agency must identify excise liabilities through manufacture or point of importation of excisable tobacco products. It must register and license activities to track tax liability. In GCC countries, the roles of Ministry of Finance and Customs must change. Customs should focus on border security, and perhaps define tax liability both for customs purposes and excise duties. The revenue agency must decide whether the tax is collected at manufacturer or wholesale level. If the excise is seen as a manufacturing tax, then the taxing point should be close to place of manufacture or collected at time of importation. If it is seen as a consumption tax, then the taxing point should be where the tobacco product enters the market for sale (regional wholesaler).

In many countries, licensees estimate their tax liability, acquire tax stamps, and affix them on product packaging before the product leaves the warehouse. IT solutions are increasingly employed to make the process more efficient. The agency must handle issues such as the fact that manufacturing or storage may involve some damage. Anti-forestalling measures should also be in place so that excise tax increases are not used as a tool to gain market share, by releasing for consumption a large quantity of products before an announced tax increase is in effect. For example, in the European Union, some Member States use a cap on tax stamps (or release for consumption), use a sell by date, a mixed system, or payment of the tax difference. The agency must control tax evasion and counterfeit products by adopting a state of the art monitoring, tracking and tracing system (see [15]).

6. GCC common market, the need for fiscal reforms and challenges

6.1 Consequences of common market, World Trade Organization commitments and free trade agreements

A free trade area between GCC countries was established in 1983, and a common market in 2008. With the exception of a few products, GCC countries apply a common external tariff (CET) on products imported from the rest of the world [16]. As a consequence, there is free movement of goods between GCC countries, with common customs regulations and procedures. Even though full integration is still to take place, due to disagreements on customs revenue sharing among governments, there is some degree of coordination on various cross border issues. With respect to tobacco products, there has been a move towards coordinated changes in duty rates but also structure. All countries, apart from an ad valorem duty, introduced a minimum specific duty on tobacco products (see Table 1 below) to ensure a certain level of tariff revenue. The minimum specific duty was introduced first by Saudi Arabia. According to the WHO Report on the global tobacco epidemic database [1], the minimum specific duty applies to all countries apart from Kuwait in 2014.

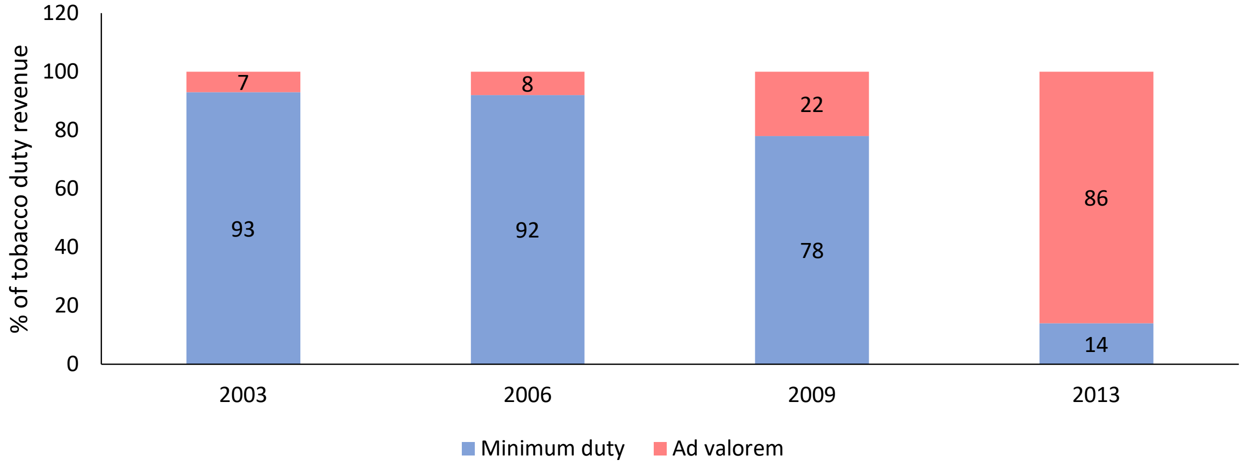
Table 1. Most-favoured-nation applied tariffs on tobacco products in the GCC

Country	Unmanufactured tobacco	Cigars and cigarillos	Cigarettes	Waterpipe tobacco
Bahrain	100% with min BD 2/gross kg	100% with min BD 15/kg	100% with min BD 10/1000 cigarettes	100% with min Fils 600/gross kg
Kuwait	100% with min KD 1.5/gross kg	100% with min KD 12/kg	100% with min KD 8/1000 cigarettes	100% with min Fils 500/gross kg
Oman	100% with min OR 2/gross kg	100% with min OR 15/kg	100% with min 10/1000 cigarettes	100% with min Ps 600/gross kg
Qatar	100% with min OR 20/gross kg	100% with min 150/kg	100% with min 100/1000 cigarettes	100% with min OR 6/gross kg
Saudi Arabia	100% with min SR 20/gross kg	100% with min SR 150/kg	100% with min SR 100/1000 cigarettes	100% with min SR 6/gross kg
United Arab Emirates	100% with min DH 20/gross kg	100% with min DH 150/kg	100% with min DH 100/ 1000 cigarettes	100% with min DH 6/gross kg

Source: www.tariffdata.wto.org.

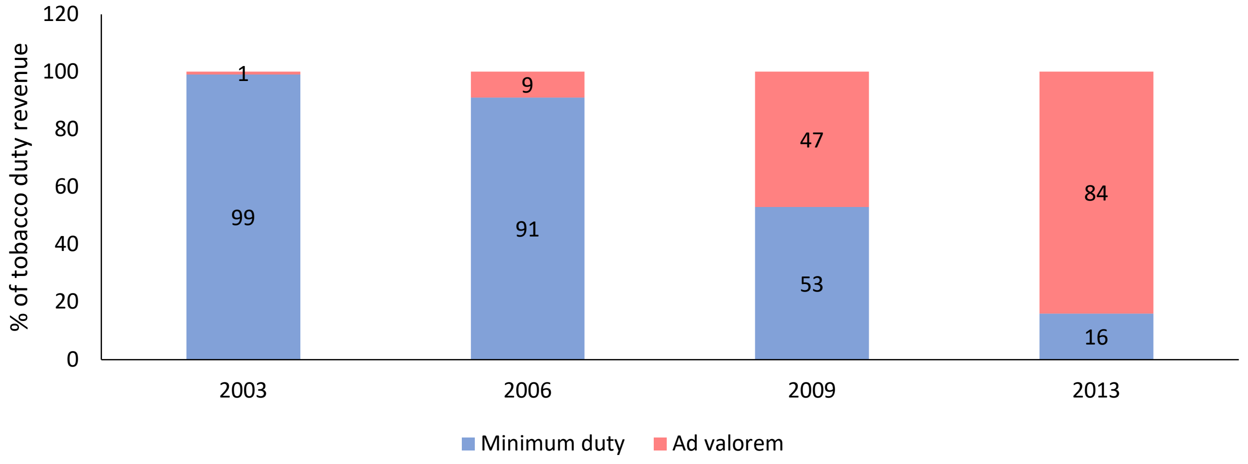
There is evidence that tobacco companies lobbied to ensure that all Member States adopt a high minimum specific duty so that all cigarette brands are taxed, effectively, on a per unit basis [17]. An increase in the specific duty is likely to imply that all brands must pay the minimum amount of duty regardless of their CIF (cost, insurance and freight) price. An increase in the ad valorem rate benefits the lower-priced brands. Saidi reports that the minimum specific duty was not adjusted for inflation regularly, and its real value has been falling over time [18]. According to Saidi [18], as manufacturers increased prices for many brands over the years, cigarettes were increasingly subjected to the ad valorem duty. This is shown for Saudi Arabia, United Arab Emirates and Kuwait in Figures 4, 5 and 6 below.

Figure 4. Evolution of duty revenue by source in Kuwait



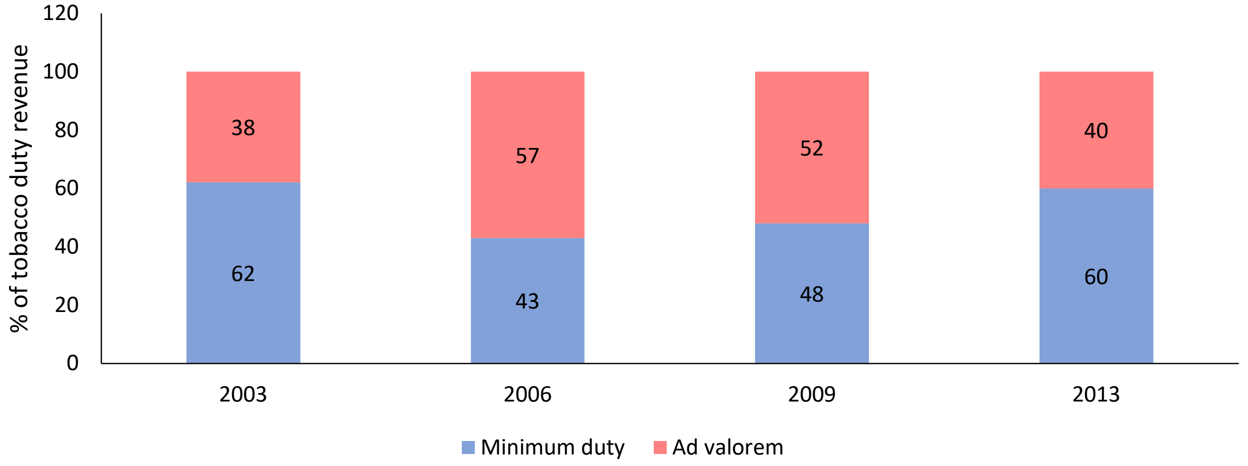
Source: [18].

Figure 5. Evolution of duty revenue by source in Saudi Arabia



Source: [18].

Figure 6. Evolution of duty revenue by source in United Arab Emirates



Source: [18].

GCC countries are members of the World Trade Organization (WTO) and grant most-favoured-nation treatment to their trading partners. As WTO members, they have to implement the Customs Valuation Agreement (CVA) and comply with the binding maximum import duties. Table 2, below, shows the GCC bound rates on tobacco products. Kuwait and Qatar impose some other fees and charges on imports, for which there are also maximum binding rates.

Table 2. Bound rates on tobacco products in the GCC

Country	Unmanufactured tobacco	Cigars and cigarillos	Cigarettes	Waterpipe tobacco
Bahrain	100%	35%	35%	35%
Kuwait	100%	100%	100%	100%
Oman	150%	150%	150%	150%
Qatar	200%	200%	200%	200%
Saudi Arabia	200% or SR 36/gross kg whichever is higher	200% or SR 300/kg in direct package whichever higher	200% or SR 200/1000 cigarettes whichever is higher	200% or SR 80/net kg whichever is higher
United Arab Emirates	200%	200%	200%	200%

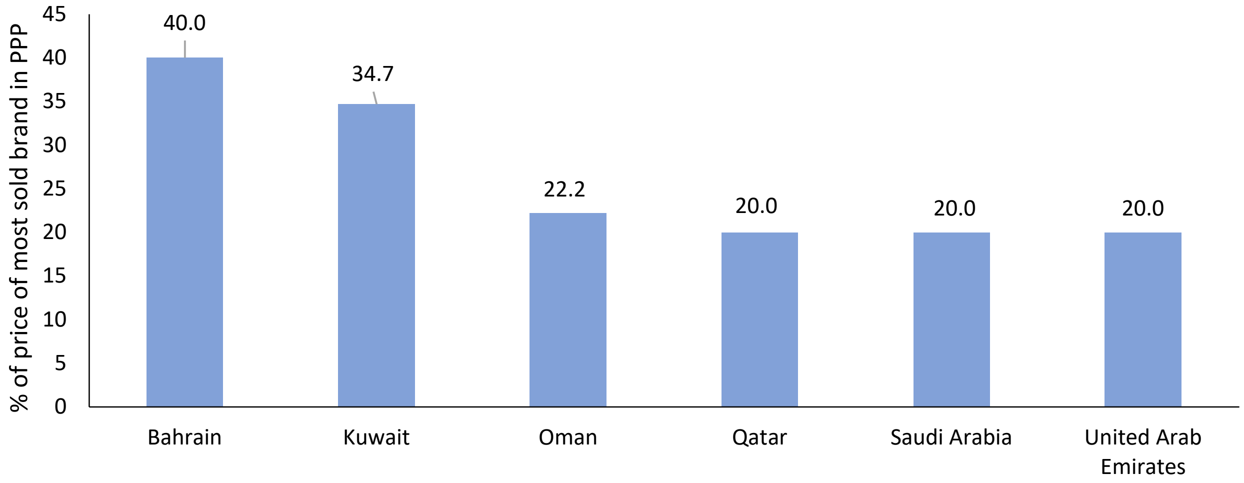
Source: www.tariffdata.wto.org.

Bahrain and Oman have a free trade agreement with the United States, effective from 2015 and 2018 respectively. The GCC has decided that future regional agreements have to be negotiated as a group. There is also an free trade agreement between the GCC and Singapore (entered into force in 2013), and between the GCC and the European Free Trade Association (not yet implemented). There are ongoing negotiations with a number of other countries. International and bilateral agreements come with some obligations, including the gradual phasing out of import duties. These obligations restrict the participating member's choices in terms of instruments used to achieve certain objectives.

6.2 Cigarette prices and duty shares in the GCC

Since international and bilateral agreements restrict the choices that GCC countries have to achieve certain revenue and health objectives, governments need to replace the revenue lost due to tariff reduction and elimination, and to replace import duties with consumption taxes in order to curtail harmful consumption. Figure 7, below, shows the import duty as a percentage of the retail price of the most sold cigarette brand in each GCC country, in 2014.

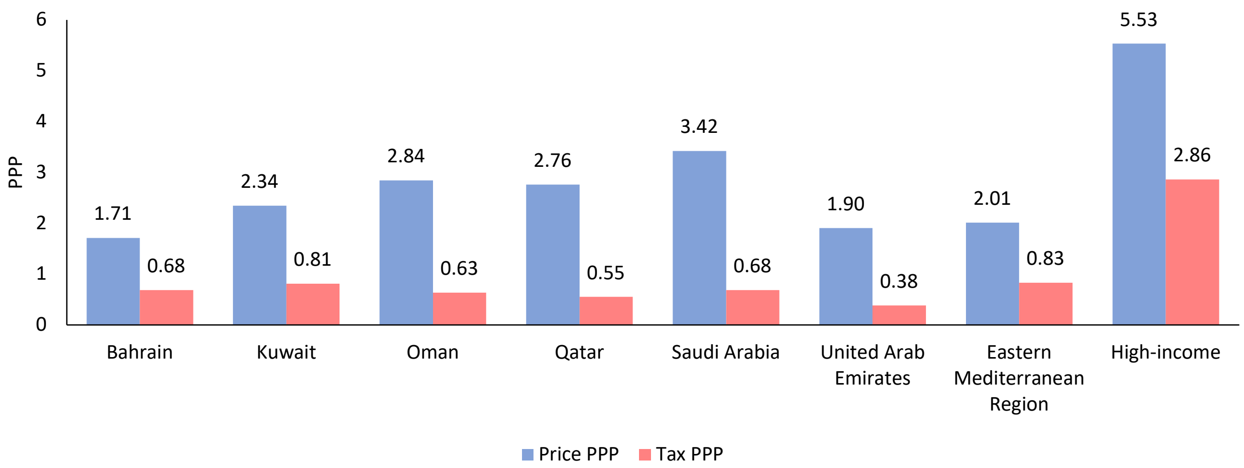
Figure 7. Import duty as % of price of most sold cigarette brand, 2014



Source: [1]. Notes: For all GCC countries except Bahrain, the most sold brand is Marlboro. In 2014, Bahrain reported its cheapest brand as the most popular brand, hence the import duty accounts for a higher percentage of the price.

For all countries, but Bahrain, the most sold brand is Marlboro. In 2014, Bahrain reported a change from Marlboro to John Player Gold Leaf (the cheapest brand) as the most popular brand, hence the import duty accounts for a higher percentage of the price. Using the price of the most sold brand in 2014, we see that, even though the price is higher for most countries, the duty paid per pack in GCC countries is lower than the average tax in the Region. If we compare it with the average tax in other high-income countries, both prices and (especially) overall tax levels are much lower (see, Figure 8).

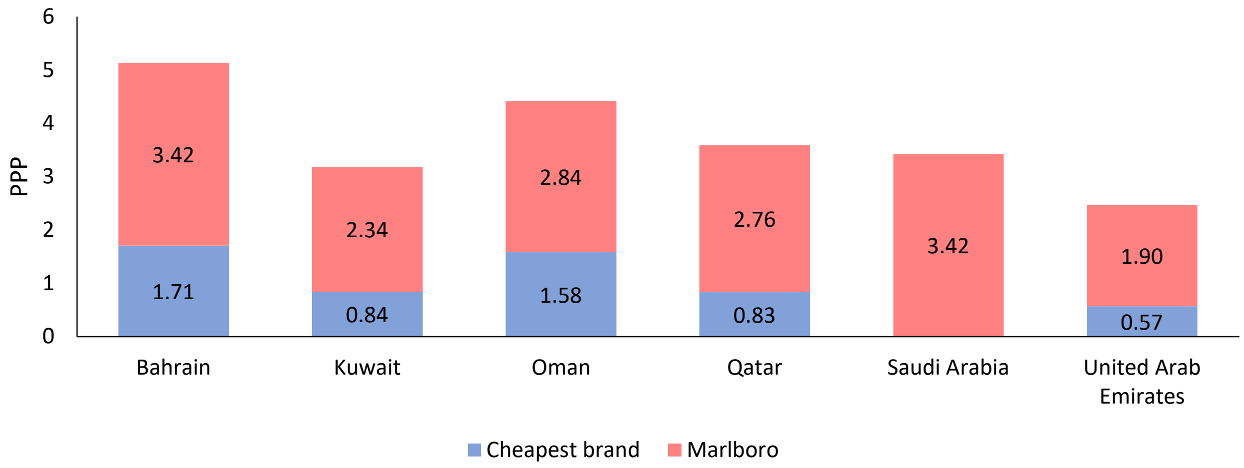
Figure 8. Price of most sold brand and tax per pack, 2014



Source: [1].

Figure 9, below, shows the prices for Marlboro and the cheapest brand in each country. United Arab Emirates have the lowest price and tax level among GCC countries.

Figure 9. Retail Price in PPP for Marlboro and cheapest brand, 2014

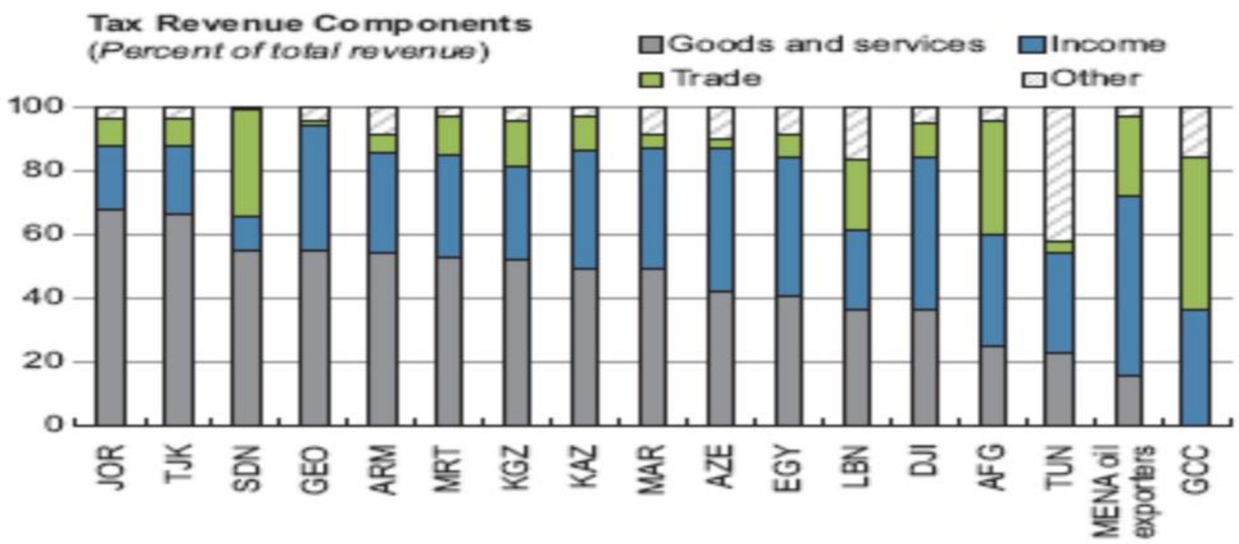


Source: [1]. There is no information for the cheapest brand in Saudi Arabia.

6.3 Politics and economic feasibility

As Figure 10 below indicates, the main non-hydrocarbon revenue for GCC countries comes from trade taxes.[2] As WTO commitments and free trade agreements constrain countries from raising import duties on cigarettes and other tobacco products, and often require lowering them, their ability to increase prices and reduce tobacco consumption, while at the same time increase revenue, is compromised.

Figure 10. Tax revenue by source, certain countries



Source: [19].

International best practices suggest that governments impose excise taxation to raise revenue and, increasingly, to control consumption of harmful products, a practice which does not violate any international obligations. This, of course, raises issues with respect to administration, compliance and enforcement of such

[2] If a (harmful) product is manufactured in a GCC country, then there will be no tax all.

taxes. Each government must build the capacity to implement the required reforms, define and monitor taxable activity, enforce tax payments and collect revenue.

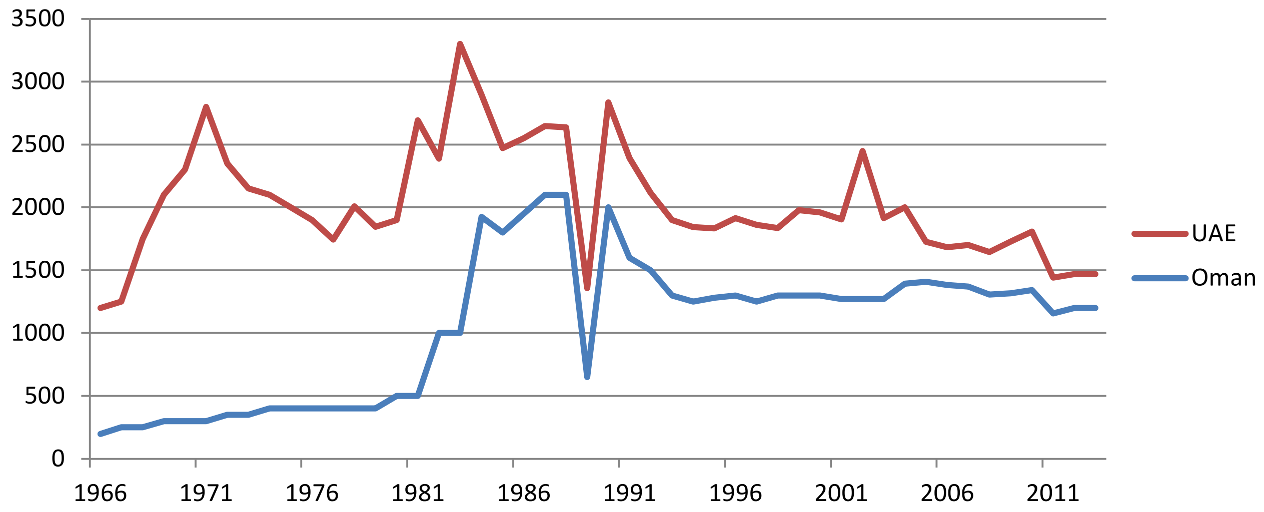
GCC governments must coordinate in many ways to avoid tax arbitrage opportunities and illicit trade. A clear definition of excisable tobacco products is needed to monitor distribution of these products and to safeguard revenues. All tobacco products, including e-cigarettes, should be included in the list of excisable products. Encrypted tax stamps or more state of the art tracking and tracing systems should be adopted. Finally, the appropriate rates and structure must be defined, including minimum excise taxes. Neither in the United States nor in the European Union are tobacco tax rates completely harmonized. Some variations in tax rates do exist but at the cost of cross-border shopping and bootlegging [13].

Designing the optimal tax structure and calculating the optimal tax rate is not easy. Tobacco markets are characterised by market power as well as negative externalities (and internalities, as defined in section 5). This makes the calculation of the right tax complex. Government agencies need to have information about: (a) domestic market structure, that is, about the number of tobacco companies in the market and their market share; (b) firms' strategic pricing and the degree to which they pass the tax on to consumers; and (c) consumers' responsiveness to tax, price, and income changes (that is, tax, price, and income elasticities of demand for tobacco products).

Optimal rates, however, might not be feasible. Feasibility depends on other economic as well as political dimensions. With respect to economic factors, industry regulation, agency organization and tax administration, tax compliance and enforcement, and opportunities for tax avoidance and evasion, all affect the final outcome. As for political dimensions, concerns over jobs in the agricultural or manufacturing sector, if such sectors exist in the country, or the apparent regressivity of the tax, can arise.

In the GCC almost all tobacco products are imported. Tobacco is grown only in Oman, in very low quantities, and United Arab Emirates, in even smaller quantities. Figure 11, below, shows the trend in unmanufactured tobacco production in Oman and United Arab Emirates since 1966. Tobacco growing in Oman has no significant impact on the overall Omani economy. The impact is even smaller in United Arab Emirates. Governments can help the few hundred local farmers diversify to other environmentally suited, profitable crops. Arguments that diversified crops are not going to be as profitable as tobacco growing should not matter as, for any remaining negative economic impact, farmers can be compensated via targeted programmes that are financed by the collected tobacco tax revenue.

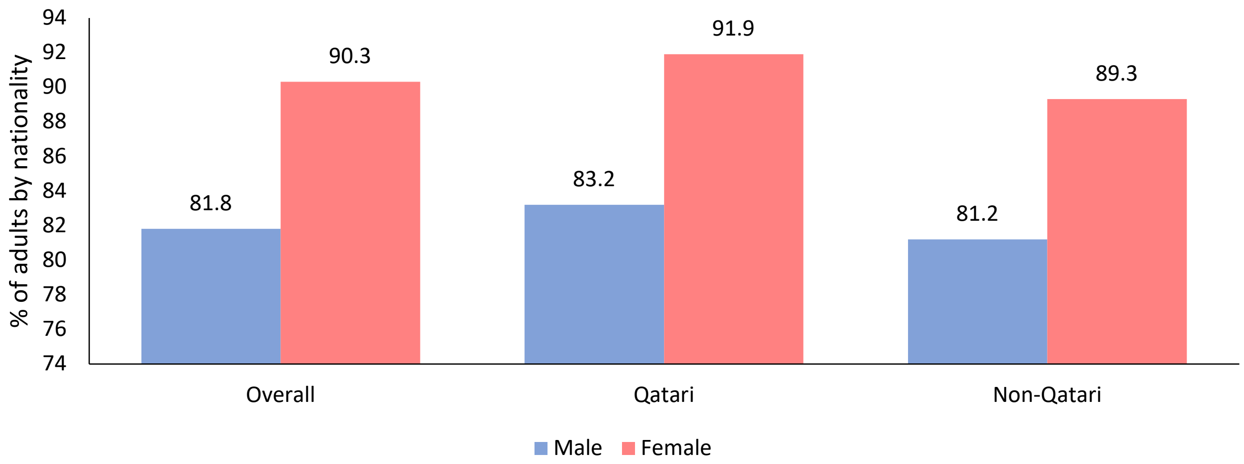
Figure 11: Tobacco production in the GCC (tons)



Source: Data from www.faostat3.fao.org.

In general, to impose new taxes, replace old ones or raise tax rates effectively requires a competent bureaucracy. To reform taxes successfully requires political effort to secure taxpayer consent. In most countries, a majority of the population supports the use of taxation, among other complementary instruments (see [20]), for public health reasons. See, for example, Figure 12 below for Qatar.

Figure 12. Adults who support increasing taxes on tobacco products, by nationality



Source: GATS Qatar, 2013.

Evidence indicates that income growth also has an influence on tobacco product consumption (the 'affordability' issue). Most estimates of the income elasticity of demand (capturing demand sensitivity to income changes) lie between 0 and 1 indicating that, as income increases, consumption will increase to a certain extent [13].[3] This implies that tax rates should be adjusted not only for inflation (price increases) but also income increases in order to ensure that the affordability of tobacco products is falling over time.

[3] There is evidence of declining income elasticity in the USA and other high income countries.

7. Concluding recommendations

Increased oil supply from unconventional sources and rising energy efficiency puts downward pressure on oil prices. In addition, fluctuating expectations for global demand and geopolitical risks lead to oil price volatility. GCC countries themselves recognised that they had to address oil price volatility, but there was never an agreement on how to do this (see, for example, [21] for a historical overview). The issue of taxation in GCC countries has been open for the last couple of decades. Since the late 1990s, international organizations have encouraged GCC countries to implement tax policies. Taxation, in general, is not seen only as a way to raise revenues but as a way to build accountability [22].

With growing populations and expanding economies, in spite of their strong economic performance, GCC countries face large increases in government spending and rising fiscal vulnerabilities. As domestic energy consumption increases, export volumes will decline. Moreover, an increasing number of bilateral and regional agreements require a reduction in customs duties. In the case of harmful products, such as cigarettes and other tobacco products, taxation is also a public health policy. With fast-growing populations, that is, a high number of potential tobacco users, and weak tobacco control measures, GCC countries are fertile ground for tobacco multinationals (for example, Philip Morris International has established a regional headquarters in United Arab Emirates).

GCC governments need to act quickly and in a coordinated manner to protect both their budgets and public health. Some general recommendations include the following:

- With respect to excise taxation of tobacco products:
  - From a health perspective, the tobacco tax is a corrective tax and as such should be distinct from a general sales tax (e.g. VAT).
  - From a revenue perspective, tobacco excise tax revenue can compensate for the reduction in revenue from import duties.

- With respect to tax design (tax structure and tax level):

  - A uniform specific tax (a tax based on quantity) is simple and effective in reducing consumption of tobacco products and in generating stable, predictable tax revenues. The excise tax level is recommended to be at least 70% of the retail price.

  - All tobacco products should be taxed comparably in order to minimize opportunities for substitution.

  - Tax rates should be regularly adjusted for inflation and income growth, so that tobacco products do not become more affordable over time.

- With respect to tax administration and implementation:
  - Build the institutional infrastructure to support effective tax administration.
  - Provide tax training to administrative staff.
  - Adopt new technologies to monitor and enforce tax collection.
  - Set high licence fees for sale of tobacco products.
  - Set swift and severe penalties for those engaging in illegal activities related to tobacco products.
- With respect to data collection:
  - Given the available data, research needs to be done to provide information about: (a) domestic market structure; (b) firms' strategic pricing in the area; (c) domestic consumers' responsiveness to tax and price changes as well as income changes; and (d) consumers' tendency towards tobacco product substitutability.
  - Understand the need to collect data in a reliable and regular manner and convert this into information. This helps governments make the right choices, given the economic, administrative and social realities.

  - If the data are made publicly available, it will also allow the public to measure governments' performance, making it more accountable.
- With respect to international coordination:
  - Any policy change, both in tax design and tax administration, should be in coordination with other GCC countries to minimize opportunities for tax avoidance and tax evasion , and to safeguard revenues.
  - Any policy change, both in tax design and tax administration, is recommended to be guided by the WHO international treaties and protocols on tobacco products.

8. References

[1] WHO Report on the global tobacco epidemic. Geneva: World Health Organization; 2015.

[2] GCC Budget analysis. Jeddah: Alkhabeer Capital; 2014.

[3] Regional economic outlook: Middle East and Central Asia. Washington, D.C.: International Monetary Fund; 2014.

[4] Hvidt M. Kuwait programme on development, governance and globalisation in the Gulf States: economic diversification in GCC countries: part record and future trends. London: The London School of Economics and Political Science; 2013.

[5] Consumption tax trends 2010: VAT/GST and excise rates, trends and administration issues. Paris: Organisation for Economic Cooperation and Development; 2011.

[6] WHO Technical manual on tobacco tax administration. Geneva: World Health Organization; 2010.

[7] Pigou A. The economics of welfare. London: Pagrave Macmillan; 1920.

[8] Gruber J. Smoking's internalities. Regulation. 2002–2003;52–57.

[9] Viscusi W. K. Cigarette taxation and the social consequences of smoking. Tax Policy and the Economy. 1995;9:51–102.

[10] WHO Report on the global tobacco epidemic. Geneva: World Health Organization; 2013.

[11] Releases for cigarettes and fine-cut tobacco consumption. Brussels: European Commission; 2014.

[12] Guidelines for implementation of Article 6 of the WHO Framework Convention on Toabcco Control. Geneva: WHO Framework Convention on Tobacco Control Conference of Parties; 2014.

[13] Effectiveness of tax and price policies in tobacco control. Lyon: International Agency for Research on Cancer; 2011.

[14] European Council Directive 2011/64/EU. Brussels: Official Journdal of the European Union; 2011.

[15] WHO Protocol to elimniate illicit trade in tobacco products. Geneva: WHO Framework Convention on Tobacco Control,; 2013.

[16] Common custsoms law: rules of implementation and explanatory notes. Riyadh: Gulf Cooperation Council; 2002.

[17] Voice of Truth (2nd edition). Cairo: WHO Regional Office for the Eastern Mediterranean; 2008.

[18] Saidi N. GCC fiscal reform: oil, government revenue, excise taxes and the tobacco market. 2014.

[19] Regional economic outlook: Middle East and Central Asia. Washington, D.C.: International Monetary Fund; 2013.

[20] WHO Report on the global tobacco epidemic. Geneva: World Health Organization; 2008.

[21] Harrison M. Taxation and the GCC states. Lancaster: Gulf One Lancaster Centre for Economic Research; 2010.

[22] Almutairi H. Competitive advantage through taxation in GCC countries. International Business and Economics Research Journal. 2014;13(5):769–778.