



International Institute  
For Legislative Affairs

## **INCREASE EXCISE TAX RATES FOR TOBACCO PRODUCTS IN KENYA: EFFECTIVE IMPLEMENTATION OF ARTICLE 6 OF THE WHOFCTC AND ITS GUIDELINES: PROMOTING PUBLIC HEALTH AND INCREASE GOVERNMENT REVENUE**

### **Executive Summary**

Governments have the potential to use tobacco taxes to manage consumption, raise revenue and promote public health. Of all tobacco-product taxes, excises are the most important for achieving the health objective of reduced tobacco consumption, since they are uniquely applied to tobacco products and raise the prices of these products relative to the prices of other goods and services. Both specific and ad valorem excises are instruments the government can use. A single-rate specific taxation would lead to relatively higher price increases and reduce the market share of cheap cigarettes. In addition to specific taxation, depending on the characteristics of the product consumed most widely and the structure of each industry, the government can also impose an ad valorem tax to adjust specification attributes (appeal and variety) to a desired level and raise the required revenue.

The long-term goal should be greater reliance on specific taxation. Raising tobacco taxes so that they account for at least 70 percent of retail prices would lead to significant price increases, induce many current users to quit, and deter numerous youth from taking up tobacco use, leading to large reductions in the death and disease caused by tobacco use. At the same time, such tax increases will generate significant increases in tobacco tax revenues. Taxing all tobacco products consistently reduces the potential for substitution among them.

Variability in tobacco excises is a reflection of differences in governments' objectives and the constraints they face. Higher revenue targets may be

constrained by administrative issues. A well-designed tax system is not enough if the tax administration agency is lacking the technical and human capacity needed to implement and enforce it, as well as to reassess the system in the light of changing circumstances. Simplicity and transparency in tax structure and administration reduce administrative and compliance costs, as well as opportunities for tax avoidance and tax evasion, leading to higher and sustainable tax revenues.

Tax avoidance activities, by both consumers and producers, constrain government's ability to raise revenue and control consumption through taxation. Simplifying the tax structure will help reduce opportunities for tax avoidance as well as monitoring costs per unit of revenue raised. Tax evasion involves both illicit trade and illicit production; it may involve genuine products or counterfeit. High tax increases may provide financial incentives for smuggling, when enforcement and tax laws are weak, penalties are small, and it takes a long time to prosecute smugglers. Up-to-date technologies and a coordinated action including international collaboration, strengthened administration and enforcement with swift penalties are required.

Whether or not tax increases fall more heavily on low-income groups depends on how tobacco use among low- and high-income groups changes in response to these tax increases. Higher taxes on all tobacco products lead to a relatively large reduction in tobacco use among low-income groups and an increase in the overall share of tobacco-product taxes paid by higher-income groups. Thus, tobacco tax increases result in a progressive distribution of the associated health and economic benefits. Moreover, at least part of the extra revenues generated can be used to support public programmes targeted specifically at low-income groups.

In most countries, tobacco tax increases will have either no net impact on employment or, more likely, would lead to a small increase in the number of jobs. Any reductions in tobacco-dependent employment, following tobacco tax increases, would therefore be offset by increases in employment in other sectors.

Crop-diversification programmes that support farmers and programmes retraining those involved in tobacco product manufacturing could be financed by a small portion of the extra revenues generated from increases in tobacco product taxes.

Governments need to establish a mechanism for adjusting specific taxes to keep pace with inflation and increases in real income. The latter is more

important in low- and lower-middle-income countries because the evidence suggests that in these countries tobacco consumption increases as income rises. In most countries, tobacco-product taxes constitute a low share of prices of tobacco products and/or little weight is given to tobacco product prices in computing price indices. Thus, in general, tobacco tax increases will have little impact on inflation.

Increasing tobacco-product taxes increases tax revenues over the short to medium term, because tobacco-product taxes account for a fraction of tobacco product prices and the percentage reduction in tobacco use resulting from a price increase is smaller than the percentage increase in price in most countries. A growing number of governments have used the revenues generated by tobacco excise tax increases to fund a variety of tobacco control activities and other health promotion efforts, while others have used these revenues to finance parts of their health-care systems.

### **Policy Rationale**

The public health rationale for raising non cigarette tobacco excise taxes is much the same as the rationale for raising cigarette excise taxes. Increasing the price of tobacco products by raising tax rates reduces the demand for the products, which in turn, leads to significant reductions in the use of tobacco by current consumers and in the initiation of tobacco use by youths, significant reductions in health care and productivity costs related to tobacco use, and significant increases in state revenue. Tobacco tax reforms that raise non-cigarette tobacco tax rates, make them parallel to the tax rates for cigarettes, and improve regulatory mechanisms will help curb this phenomenon, drive down tobacco use and related costs, and increase state revenue.

### **Taxation**

Tax levies are the most effective means of preventing tobacco use, by raising the barrier to initiation. It also leads to reduced consumption, as the opportunity cost of an expensive habit competes with other needs.

There are two types of taxes:

1. Specific taxes on a given quantity of a product (e.g., a tax paid on each pack of cigarettes sold); and
2. Ad valorem taxes as a percentage of price.

Some countries use both to maintain steady revenue as a barrier to tobacco industry influence on retail price and to keep up with inflation. **Regardless of the mechanism, taxes should increase to keep costs above consumer purchasing power and inflation.** At the same time, it is important to ensure that taxes are levied on all products, including those that are less expensive, to avoid substitution. Revenue earned through taxation can be used for other tobacco control measures; a use that often enjoys high approval among the general public.

Studies find that a 10% increase in tobacco price would result in a 6% decrease in tobacco consumption in MICs. WHO recommends that tobacco excise taxes be at least 70% of retail sales price. Few, if any, countries in Africa have achieved this best practice. “

### **Policy status and development in Kenya**

The National Treasury (formerly Ministry of Finance), through the Department of Economic Affairs, is responsible for the development of statutory tax policies covering taxes, as well as administration. Tax policies are released either as an act of Parliament or through regulations gazetted by the Cabinet Secretary. The Constitution enacted in 2010 introduced significant changes to the process of developing tax laws. Although the National Treasury (NT) retains its role, Parliament, through the Budget Committee, is given enhanced powers to review and amend. In line with this, the Constitution requires the NT to submit budget proposals, including tax proposals, at least two months before the beginning of each financial year.

The NT has been grappling with restructuring tobacco taxes for more than eight years, having changed the structure three times during this period. Prior to 2003, excise tax on cigarettes was charged on ad valorem rate based on the ex-factory selling price. This system was replaced with a four-tier specific tax based on the retail selling prices. In 2008, the MOF made a major structural change, introducing taxation on the basis of product and packaging characteristics. However, as a result of Industry lobbying, the change was reversed by Parliament in 2010. In 2011, the NT proposed to Parliament a new tax structure in which the tiers were abolished and all taxes were based on a single rate of 1,200 Kenya shillings (Kshs) per mille or 35% of the retail selling price, with the latter targeted at the high-end tobacco products.

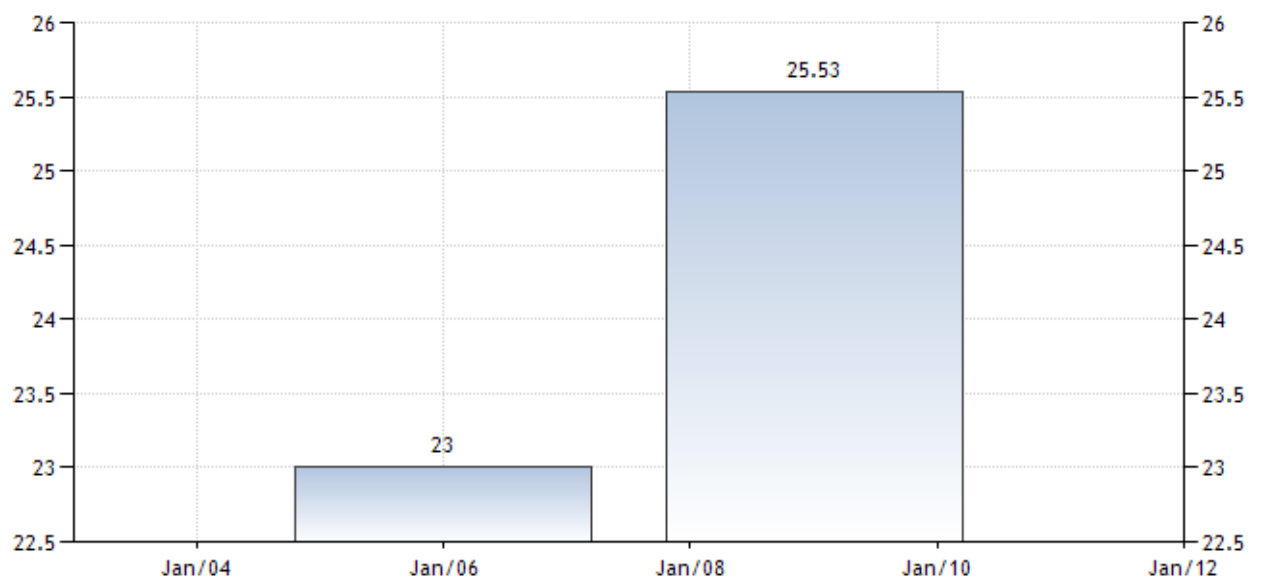
The new structure raises taxes on the lower-end tobacco products by approximately 82% and results in a global increase of approximately 35%.

## Smoking prevalence

### Smoking prevalence - males (% of adults) in Kenya

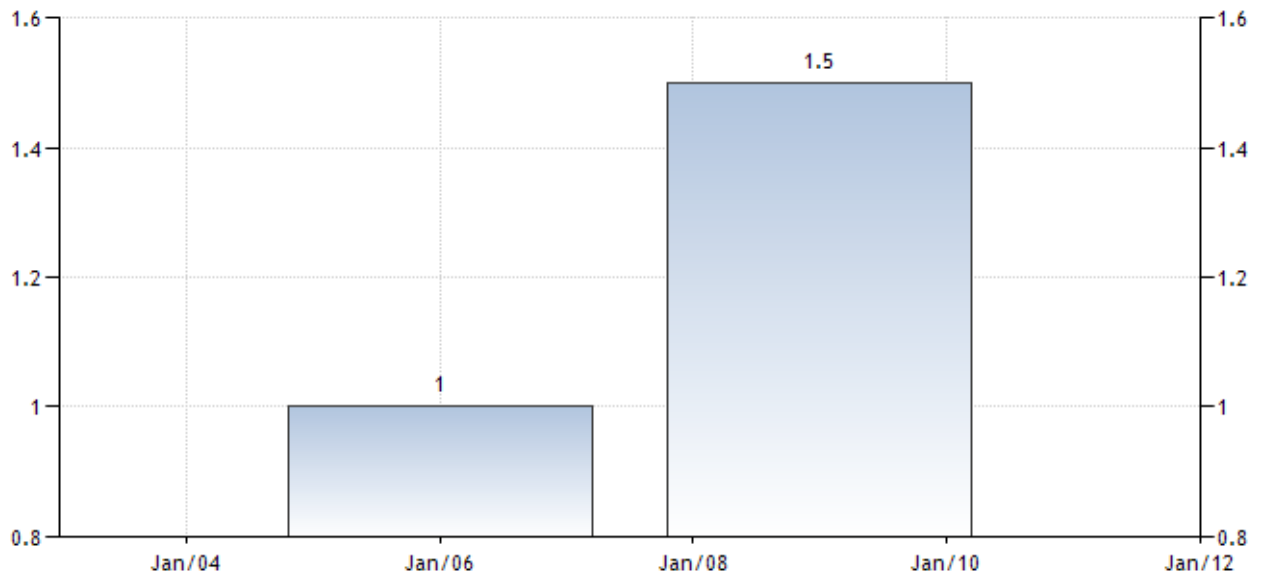
Smoking prevalence; males (% of adults) in Kenya was last measured at 25.53 in 2009, according to the World Bank. Prevalence of smoking, male is the percentage of men ages 15 and over who smoke any form of tobacco, including cigarettes, cigars, and pipes, and excluding smokeless tobacco. Data include daily and non-daily smoking.

**Figure1:**



### Smoking prevalence - females (% of adults) in Kenya

Smoking prevalence; females (% of adults) in Kenya was last measured at 1.50 in 2009, according to the World Bank. Prevalence of smoking, female is the percentage of women ages 15 and over who smoke any form of tobacco, including cigarettes, cigars, and pipes, and excluding smokeless tobacco. Data include daily and non-daily smoking.



### Impact of Raising Tobacco Tax

- Results are consistent with general economic principles :
- If the cigarette excise tax rates were increased, the retail price of cigarettes would increase, as well as revenues from cigarette excise tax, VAT, and other related taxes
- tobacco consumption and smoking prevalence will drop
- The key factors that affect the magnitude of the impact of a tax increase:
  - a. the percentage change in industry (net-of-tax) price
  - b. the price elasticity of tobacco demand
  - c. the percentage change in industry (net-of-tax) price
  - d. the price elasticity of tobacco demand
- As long as the industry passes on the additional tax to consumers, it is evident that increasing tobacco excise tax will not have a significant negative impact on the industry's profit, while significantly increasing tax revenue and reducing tobacco consumption.

### Overall impact of cigarette tax increases on consumption and tax revenue:

Tax authorities should be aware of the market conditions and the factors affecting consumer purchasing behaviour. From a revenue perspective, large volumes of sales help generate more revenues as excises increase, despite tax-induced reduction in sales. However, a positive relationship between income and tobacco consumption can level off the expected tax-induced reductions in sales, leading to higher revenues for the government but smaller reductions in consumption.

Designing the tax structure and determining the level of tax increase should be evaluated carefully by taking into account the price and income sensitivity of consumers, so that tax policy serves both public health and revenue objectives.

However, a rule of thumb suggests that in order to achieve public health objectives by increasing prices and reducing consumption, increase in tobacco taxes should be higher than inflation and increases in income, so that the tobacco products become less affordable.

### **Have a Well-Designed Tax Policy**

A well-designed excise tax policy exhibits transparency and easy definability, increasing efficiency by reducing administrative costs. A good candidate for a well-designed tax system is a simple and unified excise tax system with all tobacco products taxed at the same level. Such a system would be an ideal system for tax authorities with respect to generating more revenues while reducing cigarette consumption. A strong case can be made for a uniform specific excise tax in terms of generating more revenues, by reducing non-compliance and unfavourable pricing strategies among producers, while reducing cigarette consumption by increasing average cigarette prices.

Furthermore, a uniform specific excise reduces price gaps between brands and tobacco products, minimizing substitution behaviour of consumers among brands and products. The impact of such a system on price gaps estimate the impact of different tax structures using comparable assumptions. The price gap in a uniform specific tax seems to be the smallest compared with all other tax structures.

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