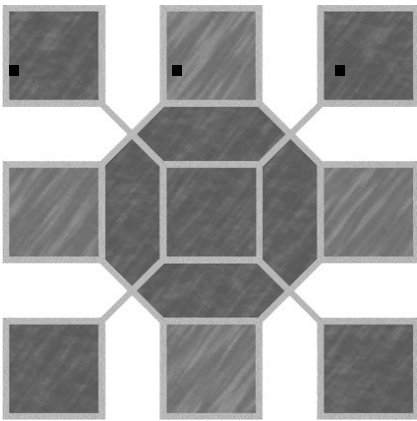


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# Unintended consequences of excise taxes



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*A speech on the  
economic, social and  
security impacts of  
tobacco duty  
harmonization in the EU*



## Background

On September 20<sup>th</sup> 2006 Eudoxa's director Waldemar Ingdahl held a speech in Prague, at the invitation of the **Liberální institut**, regarding the economic, social, and security impacts of tobacco excise duty harmonization in the European Union.

The issue is at present a very hot topic in Europe, as it involves the structure of the further development of the EU, the economic problems of the new member states and the issue of fiscal harmonization in general.

Unfortunately the debate has currently taken for granted issues regarding public health, harm reduction strategies and the social consequences of taxation. Leaving out these issues can lead to path dependence in economic policy, limiting the issue as just regarding the adoption of a common excise tax policy or bust, without exploring alternative paths that could lead to better social results.

## Unintended consequences

Excise taxes are an ancient phenomenon. Since they have lower collection costs than income taxes, they were often the preferred method of taxation by many governments prior to the 20<sup>th</sup> century.

Tobacco in particular has seen excise taxes being levied on it, and those taxes were often the most stable and profitable revenues for the government. To give you an example, in the days of the government tobacco monopoly in Sweden, excise taxes on tobacco could account to as much as 13 per cent of government revenues up until the 1940's. Today, they account for less than 1 per cent of the government revenues, but in other countries they still are an important source of revenue.

From initially being instituted for moralist, protectionist or revenue reasons the scope now has shifted to public health reasons. Establishing clear criteria for taxation has proved to be a difficult issue for the European Union ever since the basic structure was laid down in a Directive from 1972. So far, there has only been an establishment of a total excise rate at the minimum of 57 per cent of the retail price, constituted by a proportional excise duty calculated as a percentage of the maximum retail price combined with a specific excise duty calculated per cigarette unit (ranging between 5-55 per cent of a fixed monetary amount per 1,000 cigarettes). The southern member states, with a domestic tobacco production, prefer proportional taxations. The northern member states prefer a specific excise tax as they mainly import cigarettes (with the exception of Sweden that follows the proportional model).

Some countries have chosen the minimum level of the specific element, while others have adapted highest level, contributing to a considerable price variation within the EU.

Cigarettes are the most taxed substance in the world, as they are taxed at 75 per cent of the retail price; variations in the calculated price per unit make a great difference in price at retail level. If differences are too great it becomes very profitable to smuggle them or to shop cigarettes at the border of low tax jurisdictions. Therefore the EU states that a harmonization of tobacco excise taxation is needed up to western European levels as smuggling has reached enormous proportions, particularly in Estonia, Latvia, Lithuania and Poland.

Often tobacco excise taxation is seen as an innocuous way to improve public health, but there is a downside effect. Policymakers too often do not consider this effect when raising tax revenues to stomp out tobacco use. Namely, the effect that people respond to government created economic incentives, producing unforeseen consequences, even for such an unpopular product as tobacco.

Is harmonization good? Not if it turns people to the black market and towards low cost cigarettes, as cigarettes show low changes in demand regarding to price. That demand is then satisfied outside the legal venues. Studying examples of previous tax hikes we can see that what starts with border shoppers, buying directly from low taxation jurisdictions to expropriate tax differentials, soon is replaced by organized crime attracted by the huge profits and the low penalties for getting caught in smuggling. Sharp increases in tax rates result in falling sales of taxed cigarettes, with declines of government revenues.

We can see this development in the United States in the 1960's when the state of New York doubled its cigarette tax in 1965. Organized crime started to prey on border shoppers driving them out of business, and also on the legitimate businesses, robbing truckers and wholesale retailers. The dramatically increased rates for insurances and security drove costs up, further increasing the profits of the mobsters, who also started to infiltrate companies and government. The Governor at that time, Nelson Rockefeller, called for stronger federal regulations, stronger regulations on distribution channels, increased law enforcement but by 1970 the state was barely making a dent in the flow of smuggled cigarettes. In 1965 the state seized 70,000 smuggled cartons, in 1970 112,000 cartons, as smuggling had sky rocketed. The New York state committee of investigation estimated that between 1966 and 1971 the legitimate industry lost sales of \$10 billion (in today's value) and the state lost \$294 million in excise tax revenues due to smuggling. The raise in excise taxation had in fact created a dual distribution system, where the well established illegal market was fraught with turf wars and the legal market dealerships looked like fortresses. The response was to introduce a law prohibiting transport of large quantities of cigarettes across state lines, but the ban mainly shifted organized crime's focus from smuggling to robberies against legal transports inside the state of New York.



What ultimately alleviated the situation was a de facto tax reduction in the period of 1976 to 1982 as high inflation rates dropped real excises taxes by 40 per cent. According to the CDC, New York saw no significant changes in smoker rates in the population despite the high tax policy, with rates dipping from 24.4 per cent in 1991 to just 23.2 per cent in 2001, and even showing a slight increase among young adults.

The introduction of the World Wide Web in 1994 saw the setting up of websites selling cigarettes from low tax jurisdictions. The internet sales also made it very difficult to identify the vendor's country of origin for purposes of taxation. Taxed sales fell in the period of 1994 to 1996 from 79 per cent of the market to 73 per cent and hit the state of New York particularly hard. Governor George Pataki tried to effectively ban the citizens from making purchases on the internet in order to save revenues, before finally being overturned. Major Bloomberg's tax increase in 2002 (raising the tax on a packet of cigarettes to \$7.50) only served to increase the profits in bootlegging, strengthening organized crime and re-introducing large scale border shopping. The ATF reported a sharp increase in truck hijackings and robberies as the larger transports due to regulations increased the profits made by a single hold-up.

In addition, terrorist groups started to enter the smuggling racket. Counterfeit cigarette tax stamps were already found in an apartment rented by the terrorists arrested for the attempted bombing of World Trade Center in 1993, and rise of the Hezbollah has been credited to its massive profits in cigarette smuggling. The entry of these groups with a high propensity for violence on this racket is a dangerous development, particularly since the infrastructure needed for smuggling cigarettes could well be used for other purposes such as trafficking and smuggling of uranium.

It is important that Europe avoids the American development, but we already see signs of it. The European Commission identifies 50 smuggler networks being active in the EU, a number that is probably too low. Vietnamese crime gangs started an open war over cigarette profits in Germany in 1996.

In 1997 Sweden raised its excise tax on cigarettes by 63 per cent, resulting in a drop in legal sales of 25 per cent in the first quarter of 1998. The Swedish customs stood largely powerless to affect the quick establishment of smuggling rings and the first large scale establishment of organized crime in Sweden. Panicking from the sharp decline in legal cigarette sales and the brisk trade over the internet, then tax minister Thomas Östros was even inclined to eliminate postal secrecy giving the Post Office the order to open all packages. Ultimately, we retained postal secrecy but its shows the dire straights that the Swedish government had put itself into. Publicly humiliated, the Swedish government had to concede that it was unable to uphold its own legislation and lowered the excise taxes on the August 1<sup>st</sup> 1998.

While the reduction put a dent in the spiralling profits from smuggling and border shopping, it has continued. The Swedish customs confiscated 1.35 million cigarette packages in 2002, a number that increased to 3.7 million in 2003.

In 2003 there was a recent general strike among 90 per cent of the tobacconists in France, protesting the raise of the excise tax also with acts of civil disobedience and demonstrations.

Norway may not be a member of the EU, but as a member of the EEA it is well worth observing. Norway's excise taxes on tobacco are higher than the EU's top rates, which has resulted in a brisk border shopping on its border with Sweden. The customs in central Norway confiscated 117,000 cigarettes, 950 kilograms of tobacco and 108 kilograms of snus in September 2006.

Eastern Europe is to harmonize to the minimal levels of excise taxes by 2009, but those minimal levels are still too high for nations where the average standard of living might not reach EU average for decades to come. It has been stated today that if the rate of smuggling reaches 20 per cent of the domestic market the excise tax policies will most difficult to maintain. Some of the new member states are already there. Despite doubling its rate of confiscations every year since 2001, the Lithuanian customs still expect further raises in smuggling. It cannot be discarded that the Gyurcsany government's recent excise tax hikes was partially responsible for the riots and civil unrest in Hungary.

But the differences in levels of excise taxation also provide incentives for smuggling in Western Europe, for instance it is calculated that 12 per cent of all domestic sales in Finland are in fact smuggled cigarettes. The WHO estimates that more than 20 billion packs of cigarettes are smuggled worldwide today.

Besides smuggling and border shopping the high excise taxes have also created a market for low cost cigarettes in Europe, where tobacco companies decrease quality to lower prices. It was calculated that in 2003 low cost cigarettes with minimum excise tax accounted for 50 per cent of the Swedish market. Before instituting a minimum excise tax of 90 per cent of the "most-in-demand" price band a trade association calculated that its members lost €65 million in revenues and the government €100 million in lost excise taxes, while effectively lowering cigarette prices.

Smuggled cigarettes also endanger smokers' health further. The Swedish government recently warned on its website that new wave of illegally produced cigarettes contain far higher levels of carbon monoxide and tar than the set standards.



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Do excise taxes really pay off for governments? Often it is stated that they compensate the governments for their increased costs in health care. An interesting study made in 2001 by Louise Roberts at Lund University "Do smokers pay for their sin?" may provide food for thought also from an international perspective. This as Swedish research often has access to excellent data collection, thanks to the Swedish Statistics bureau, providing more encompassing and reliable studies.

The study found that smokers cost the public sector a net of €92,200 more than non-smokers subtracting taxes due to increases in hospitalization, sick leaves, and elder care despite living on average 4 years shorter.

In a comment on the study professor Björn Lindgren of Lund University noted that raising the excise taxes still would not cover the costs incurred by smokers, while increasing smuggling. He proposed an alternative financing with risk differentiated premiums, where smokers pay more to social security insurances, focusing the costs on those who cause them. Thus smokers pay for their increased risk, while still preserving their free choice.

When comparing the results with later studies, showing in 2005 that smoking cost the Swedish government €2.89 billion (compared to sick leave absenteeism's cost of €2 billion) and the excise tax raising a mere €900 million in revenues, the proposal bears consideration.

The attempts to uphold the excise taxes have seen the introduction of increasingly more advanced methods such as more advanced tax pay markings and unique serial numbers on the cigarette cartons. Stiffer penalties and increased funds for law enforcement may not be as successful as often portrayed, while they do increase the costs for legal cigarettes.

Maybe a better alternative would be to benchmark excise taxes to tobacco prevention. Today it does not receive that much funding in comparing to the strategy that excise taxes will reduce smoking due to high prices (in Sweden it receives only 28 per cent of the funding given to drug prevention). As neurological studies on tobacco addiction progress, it is more feasible to see smoking as a chronic disease rather than a lack of character. Studies show motivational changes in habits that create addiction, and with a focus on the biological and psychological reasons of tobacco addiction it could well be possible to address the hard-line smokers that are decidedly unaffected by raises in tobacco excise taxes.

Another alternative could be to expand on the instrument of minimum rates set for specific products, differentiating excise tax rates towards products suitable for a harm reduction strategy.

One such example for a harm reduction strategy can be observed in the Swedish moist oral tobacco called "snus". Sales in the EU are banned since 1992, with Sweden getting an exception to the ban since its entry in 1995.

Part of the reason for daily smokers numbers in Sweden falling from 50 per cent in 1960 to 18 per cent today (Sweden is one of the few countries that matches the WHO's target of 20 per cent smoker rates) is the use of snus. Smokeless tobacco is not a harmless alternative to cigarettes, but provides a venue for harm reduction. Swedish males have traditionally used snus instead of cigarettes, resulting in a smoking rate of just 17 per cent. Women have traditionally not used snus in Sweden and their figures are of 22 per cent smokers, comparable to the US and Canada. This translates into very low incidences of lung cancer in males, while the rates are at European levels for females.

Since 2001 cigarette sales are dropping by 5 per cent annually, while snus use increases by 3-4 per cent. It has been estimated that 47 per cent of all snus users are ex-smokers. A survey in 2001 including 2,000 individuals indicated that 33 per cent of those who had quit smoking had done so through the use of snus, while only 17 per cent had used other tobacco cessation methods.

When the excise tax rose in 1997 many switched to snus. As snus is regulated a foodstuff in Sweden excise taxes are comparatively lower than on other forms of tobacco. Snus is taxed by weight at €13.65/kilogram and as boxes only contain 24 grams of snus taxation is effectively lower. The positive health effects compared to smoking, the lower excise tax and public attitudes have diverted smoking to healthier alternatives. Snus could also be considered as a low cost alternative for smoking cessation in the Eastern European member countries, if the ban is lifted.

All is not well with snus, as its ban also creates problems. I have spoken of the situation at the Swedish- Norwegian border, but this is worse in regard to Finland. Finland had a part of the population using snus, but did not negotiate an exception to the ban, when entering the EU. Thus snus is now smuggled into Finland from Sweden, and sold quite openly in some stores. With a price difference of €2.50 of net gain per box sold by the smugglers it provides a quite lucrative racket. The authorities have also been lax in upholding the ban, and the Commission recently brought Finland to the European Court of Justice on charges of not upholding the ban of sales in the autonomous region of Åland and on ferries reaching the Åland islands. The use of snus in Finland has been stable since the ban at 2.5 per cent of the population, while increasing in some groups. It is estimated that among 15 to 16 years old at least 20 per cent have tried snus, which is a higher figure than the same age category in Sweden.



In conclusion, excise taxes have unintended consequences for health and security when people respond to government regulation that need to be considered when discussing further harmonization. The problems are real and affect the new member states in particular, but are not unknown in the rest of the EU. Europe as a whole needs to compare the present economic policy with sociology, new scientific knowledge on the nature of addiction, and explore new methods for cigarette substitution and harm reduction strategies.