

ICPS newsletter

Which taxation system for tobacco goods is best—combined or specific?

The draft of a new Tax Code has caused a heated debate in Ukraine that is still going on. One of the topics being discussed is the change of the excise taxation system of tobacco goods. To promote socially fair taxation and to increase tax revenues, participants of the discussion propose to switch from the existing specific taxation system, which determines the excise rate on the basis of production volume to a combined system, which determines the excise rate on the basis of volumes and product prices. Commissioned by the JT International Company, ICPS carried out an analysis of different alternatives of the excise taxation of tobacco goods. Based on the results of the analysis, ICPS came to the following conclusions: promoting social fairness cannot be considered as a priority goal of tobacco goods taxation; while both systems of taxation have the same effect on consumption, the combined system has a negative effect on tax revenues to the budget, and requires additional administrative expenditures

Objectives of taxation

Analysis of any potential changes to taxation system or to tax rates on any kind of goods should take into account the objectives of the government of Ukraine. Generally, we identify two main objectives for the taxation of tobacco goods:

- to decrease consumption levels; and
- to increase revenues to the state budget.

Another objective that is also sometimes mentioned is to provide for socially fair taxation system. However, as our analysis showed, that this objective goes against the two above mentioned ones.

First, the promotion of social fairness would lead to increased consumption levels of tobacco goods. This conclusion is based on the analysis of the structure of consumption, in which a significant share belongs to cheap cigarettes. Decreasing the taxes on cheap tobacco goods would bring their price down, thus increasing their consumption.

Second, decreasing the taxation burden on cheap cigarettes would increase the market share of this kind of product. Accordingly, the weighted average tax rate on cigarettes would decrease, and this, in turn, would reduce tax revenues to the budget.

Keeping in mind the two main objectives of tobacco goods excise taxation, ICPS analysed two possible scenarios for the

taxation system. One of them is presented in the draft Tax Code, and the other is a proposed alternative:

Scenario 1. Specific excise rate: 5 hryvnias for 1,000 sticks of non-filter cigarettes, and 10 hryvnias for 1,000 sticks of filter cigarettes.

Scenario 2. Combined excise rate: 15% of the price + 3 hryvnias for 1,000 non-filter cigarettes, and 15% of the price + 5 hryvnias for 1,000 of filter cigarettes.

In our analysis, we took into account other important adjustments proposed by the draft Tax Code, including the decrease of the VAT rate to 17%, and the elimination of the levy to the Pension Fund on the production of cigarettes.

Consumption of cigarettes and its effect on the health of citizens

According to our calculations, in both scenarios the weighted average price of cigarettes in Ukraine will decrease to about the same extent. This will be the consequence of the reduced VAT and the elimination of the abovementioned levy to the Pension Fund. These adjustments will lessen the tax burden on production in this sector.

The decrease of the average price will lead to a higher overall level of consumption of

Last week's events

New issue of the Gosudarstvennoe upravlenie v perekhodnykh ekonomikakh. A new Russian version of the *Local Government Brief* was published last week. The bulletin, published by ICPS, is commissioned by a program of the Open Society Institute titled "Local Government Initiatives".

The new issue is devoted to questions of reforming infrastructure; questions of public policy on the power industry, water and heat supply, and housing and communal services are also examined. The bulletin brings up both theoretical and practical aspects of the process of reforms. The authors point out the following main problems that post-Communist countries have to face in the process of infrastructure reform:

- lack of modern financial management;
- insufficient incentives for civil servants to implement reforms that can bring benefits to society;
- outdated system of supervision and control over the activity of enterprises;
- lack of professionalism of those working in regulatory bodies;
- limited role of civil society, represented by NGOs and mass media.

On the basis of a detailed analysis, the bulletin's authors give useful recommendations as to the following important questions:

- the selection of a privatization scheme for infrastructure companies;
- eliminating of monopolies through promoting specific types of competition;
- solving the problem of financing generally accessible infrastructure services;
- preparation and implementation of tenders for the right to provide services;
- division of risks between public authorities (especially bodies of the local government) and companies that provide services;
- tariff regulation.

In order to familiarise readers of the bulletin with the experience of infrastructure reforming abroad, the editors have published research works on this question based on an analysis of the situation in the Baltic states and in other Central and Eastern European countries. The experience of the Baltic states is considered to be the most successful example for transition economies. These countries have made significant progress in denationalisation of their national infrastructure. Experts see a direct interconnection between the successful reforms of these foundational sectors of the economy and the significant step forward made by these countries in integrating into Europe.

If you would like to receive the Russian version of the Local Government Brief on a regular basis, please fill out the form on our web-site: www.icps.kiev.ua/rus/subscription.html.

ICPS helps telecoms officials to design policy. On 13 January, ICPS presented the results of its analysis of the needs and resources of the Ukrtelekom open joint-stock company as far as informational and analytical supply is concerned. The goal of the implemented analysis is to increase the effectiveness of public policymaking in the sphere of telecommunications.

For more information, please visit Ukrtelekom's web-site: www.ukrtel.net.

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cigarettes. We estimate that, the price elasticity of demand for cigarettes in Ukraine is -0.37 (a 10% decrease of the weighted average price of cigarettes would increase their consumption by 3.7%).

As both scenarios would lead to the same price decrease of cigarettes, the effect on consumption would also be the same: consumption would increase by approximately 2,6%.

Reduction of the overall tax burden would weaken the incentives for illegal imports of cigarettes to Ukraine. Accordingly, the unofficial selling of cigarettes would also be reduced. In general, the effect of a smaller tax burden would be more or less the same in both scenarios: higher levels of consumption and decreased unofficial imports would lead to the growth of official selling by about 5%.

Establishing a combined system of excise taxation would lead to the changes in the structure of consumption (because of changed relative prices for different kinds of cigarettes): the share of consumption of cheap cigarettes (especially without filter) would increase, while the market share of costly cigarettes would be reduced. It must be noted here that cigarettes without filter are worse for human health, first of all because they contain more tars and nicotine.

Budget revenues

In forecasting future excise revenues, we took into account the described above changes in levels of consumption and of its structure. We also took into account the fact that incentives for the unofficial import of different kinds of cigarettes to Ukraine would change. Preserving existing system of taxation would make the unofficial import of cheap cigarettes to Ukraine (prices range from 0.65 to 1.5 hryvnias) the more profitable alternative. Establishing the combined system of taxation would make the import of expensive cigarettes (in Ukraine, prices range from 1.9 to 4 hryvnias) the most profitable. Thus, the structure of official cigarettes market would change; with the share of consumption of cheap cigarettes growing, and consumption of expensive cigarettes decreasing.

On the basis of these assumptions, we

calculated budget revenues from the excise taxation of tobacco goods. If the existing system remains (Scenario 1), annual budget revenues from the taxation of tobacco goods would be approximately 542 million hryvnias, while in case of the combined system (Scenario 2), the budget would gain approximately 510 millions hryvnias.

In analysing the combined system, it is also necessary to take into account other factors that can negatively affect the level of state budget revenues and expenditures.

First, the combined system would require a more complex administration, because it depends on both the amount and the price of production; thus, expenditures on administering the taxation system would grow. And what is more, the forecasting of budget revenues that depend on the price policy of producers would become more problematic.

Second, since the advalorem component of the excise in Ukraine is calculated on the basis of producer prices (not retail prices), producers will tend to set low factory prices in order to avoid additional tax pressure.

Conclusions

The choice of a taxation system depends on the objectives stated by the government. Before changing the existing system, all possible alternatives should be considered in detail and their consequences analysed. In implementing the combined system, it would be important to calculate optimal rates of both the advalorem and specific components of the excise; and to work out effective mechanisms of administering the tax. Such analysis would probably make it possible to determine taxation system for tobacco goods that would function according to described objectives more effectively than the existing one. But now, as our analysis has shown, it seems that the proposed combined system is less effective overall than the existing specific system. ■

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The full text of the survey is available on-line:

www.icps.kiev.ua/docs/other/tobacco_excise_ukr.pdf.

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ICPS is continuing its subscription drive for its publications in 2002. The portfolio of ICPS's regular publications includes:

- *Quarterly Predictions* — a quarterly economic survey presenting regular updated economic development forecasts for Ukraine;
- *New Economic Legislation* — an annual evaluation of changes in economic legislation and the impact of that legislation on the business environment and investment climate in Ukraine;
- *Policy Studies* — a working paper series focusing on key public policy issues;
- *Consumer Confidence* — a quarterly survey of household consumer expectations;

• *Economic Statistics* — a monthly summary of statistical data useful for doing business in Ukraine;

• *ICPS Newsletter* — a weekly bulletin that covers ICPS current research and projects.

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