THE NEED FOR TOBACCO TAX REFORM IN THE PHILIPPINES

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Taxation should curb tobacco use, studies and models around the world have proven. In the Philippines, however, such is not the case.

**WHY?**

Raising taxes on tobacco products has long been encouraged by the World Bank, World Health Organization, and tobacco control experts, as a proven tobacco control measure. The WHO Framework Convention on Tobacco Control (FCTC), a global treaty to which the Philippines is party, says that raising the price of tobacco through higher taxation is the single most effective way to reduce consumption and encourage tobacco users to quit. Article 6 of the FCTC in particular says that higher taxes deter tobacco use among the young and the poor, and helps all other demographics of smokers to give up the deadly habit.

Studies all over the world suggest that a 10 percent increase in tobacco taxes can bring down tobacco consumption by as much as 8 percent, particularly in developing countries. A tax increase should also directly benefit governments through increased revenues, which can in turn be used for tobacco control and other important health and social programs. It is therefore recommended by the FCTC and the World Bank that all governments increase tobacco taxes to at least 65 percent of the retail price of tobacco products.

In the Philippines, however, something seems amiss. Current tax structures have mandated a steadily increasing tax on tobacco products since 1997, and yet smoking prevalence among Filipinos has continued to rise over the last decade.

What’s gone wrong? Why is the tax program on tobacco not having the effect of reducing tobacco use in the country?

The problem does not lie with the link between taxation and tobacco use, which has been proven time and again in documented models worldwide. What needs reexamination in Philippine tobacco control efforts are the laws and tax structures themselves. The theory is sound, but the application appears to have been compromised, such that the prevailing system has been rendered ineffective with respect to bringing down tobacco consumption. For starters, even with programmed adjustments in tobacco taxes, the current tax rates on Philippine tobacco are nowhere near the levels recommended by the World Bank.

The reason we are off track and off target, apparently, is that the crafting and implementation of tobacco taxes in the country have been influenced too heavily by industry interests, and what the Philippines
Unlike that in adults, there has been a general upward trend among the youth in tobacco consumption with the exception of the period 2001–03 when a significant reduction in smoking prevalence was reported. For females, this non-declining trend is more apparent. In a span of two decades, smoking participation among females has risen considerably. These prevalence figures suggest the need to intensify tobacco control measures targeted to the youth, particularly the females. The upsurge of the smoking habit among young females potentially drives up the social costs of smoking, at least through the health channel, because mothers’ and children’s health tend to be strongly correlated.


<table>
<thead>
<tr>
<th>Year</th>
<th>Philippines</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989&lt;sup&gt;a&lt;/sup&gt;</td>
<td>23.1</td>
<td>33.9</td>
<td>6.7</td>
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<td>2001&lt;sup&gt;b&lt;/sup&gt;</td>
<td>27.1</td>
<td>37.3</td>
<td>18.4</td>
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<td>2003&lt;sup&gt;c&lt;/sup&gt;</td>
<td>19.6</td>
<td>26.5</td>
<td>13.0</td>
</tr>
<tr>
<td>2007&lt;sup&gt;d&lt;/sup&gt;</td>
<td>27.2</td>
<td>34.4</td>
<td>19.5</td>
</tr>
</tbody>
</table>

<sup>a</sup>n=1,132 (7-17 years old); Lung Center of the Philippines study.
<sup>b</sup>n=11,630 (12-17 years old); GYTS.
<sup>c</sup>n=7,883 (12-17 years old); GYTS.
<sup>d</sup>n=5,332 (12-17 years old); GYTS.
### Smoking Prevalence in 2003, by Age Group

<table>
<thead>
<tr>
<th>Age Bracket</th>
<th>Smoking Prevalence</th>
<th>Smoking Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-19</td>
<td>20.0%</td>
<td>3,489,456</td>
</tr>
<tr>
<td>20-29</td>
<td>35.7%</td>
<td>5,137,632</td>
</tr>
<tr>
<td>30-39</td>
<td>33.7%</td>
<td>3,795,176</td>
</tr>
<tr>
<td>40-49</td>
<td>37.1%</td>
<td>3,054,476</td>
</tr>
<tr>
<td>50-59</td>
<td>34.9%</td>
<td>1,905,139</td>
</tr>
<tr>
<td>60-69</td>
<td>34.6%</td>
<td>1,106,859</td>
</tr>
<tr>
<td>70-79</td>
<td>27.6%</td>
<td>435,528</td>
</tr>
<tr>
<td>80+</td>
<td>27.6%</td>
<td>139,099</td>
</tr>
<tr>
<td>All age groups</td>
<td>30.7%</td>
<td>19,063,365</td>
</tr>
<tr>
<td>Adults (20 and over)</td>
<td>34.9%</td>
<td></td>
</tr>
<tr>
<td>Youth (10-19)</td>
<td>20.0%</td>
<td></td>
</tr>
</tbody>
</table>

Source: NNHeS, 2003

### Prevalence of Current and Former Smoking in 2003, by Age Group and Sex

<table>
<thead>
<tr>
<th>Age</th>
<th>MALES</th>
<th>FEMALES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Smoker</td>
<td>Former Smoker</td>
</tr>
<tr>
<td>20-29</td>
<td>58.8</td>
<td>6.7</td>
</tr>
<tr>
<td>30-39</td>
<td>54.2</td>
<td>14</td>
</tr>
<tr>
<td>40-49</td>
<td>61</td>
<td>13.6</td>
</tr>
<tr>
<td>50-59</td>
<td>59.5</td>
<td>24.7</td>
</tr>
<tr>
<td>60-69</td>
<td>48.6</td>
<td>32.1</td>
</tr>
<tr>
<td>70+</td>
<td>35.9</td>
<td>41.8</td>
</tr>
<tr>
<td>All</td>
<td>56.3</td>
<td>15.1</td>
</tr>
</tbody>
</table>

Source: Dans et al. (2005).


<table>
<thead>
<tr>
<th>Year</th>
<th>Philippines</th>
<th>Men</th>
<th>Women</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989a</td>
<td>58.6</td>
<td>80.5</td>
<td>23.7</td>
</tr>
<tr>
<td>1999b</td>
<td>32.6</td>
<td>54.0</td>
<td>12.6</td>
</tr>
<tr>
<td>2001c</td>
<td>23.5</td>
<td>50.6</td>
<td>8.0</td>
</tr>
<tr>
<td>2003d</td>
<td>34.8</td>
<td>56.3</td>
<td>12.1</td>
</tr>
</tbody>
</table>

\(^a\) n=4,373 (18 years and over); Lung Center of the Philippines Study.
\(^b\) n=4,000 (20 years and over); NNHeS.
\(^c\) n=10,240 (18 years and over); BRFS.
\(^d\) n=4,753 (20 years and over); NNHeS.
therefore has is not necessarily what the World Bank, WHO, and global experts on tobacco control have been meaning to encourage. Indeed, there is new evidence to suggest that the existing tax laws applying to the tobacco industry may actually be aggravating and complicating the national tobacco control effort.

On the other hand, the same new comprehensive study that suggests weaknesses in the current tax laws on tobacco, also provides compelling arguments that sound, scientific adjustments in the laws may yet turn the odds back in favor of public health objectives. The Philippines may yet fix the tax structures on tobacco products, and achieve the kind of results the world is seeing in tobacco control.

This paper analyses the problems with the current tax structures on tobacco in the Philippines, and recommends some measures that may correct and improve the implementation of taxation as an effective tobacco control measure.

**High and increasing: Smoking in the Philippines**

*There is no doubt that the Philippines has a serious and daunting tobacco problem.*

Smoking prevalence in the country is among the highest in the world. In 2003, the World Health Organization Statistical Information System ranked the Philippines 5th in worldwide in adult male smoking prevalence—are percent of Filipino males 15 years and older were smokers. Adult females in the Philippines ranked 26th with a prevalence rate of 12.3 percent.

Among ASEAN members in 2007, the Philippines had the second highest smoking prevalence rate at 16.6 percent of its adult population, says the Southeast Asia Tobacco Control Alliance. Meanwhile, the WHO’s 2003 Global Youth Tobacco Survey found that among the world’s youth, young Filipinos are among the heaviest tobacco users, with the girls occupying second place and the boys in the 4th slot.

*Even more troubling, smoking prevalence in the country has been rising over the past half decade. Among male adults, the 2003 prevalence rate represents a 5 percentage point increase from 2001 levels. On the other hand, overall smoking prevalence among the youth in 2007 represents an almost 8 percentage point increase from 2003 levels.*

**Distribution of Adult Smokers by Gender and Age Group, 2003**

Male smokers tend to be younger, with majority of them (33 percent) between 20-29 years old. Categorized by income level, the lowest percentage of male smokers belongs to the highest income quartile. On the other hand, female smokers are older, with most of them falling within the 50-59 age-group. In terms of income, most females congregate in the highest income quartile bracket.

*Source: National Nutrition and Health Survey, 2003.*
The economic and social costs of smoking

The high and increasing prevalence rates have important public health implications. This is no longer up for debate: The Department of Health says smoking-related illnesses—cerebrovascular diseases (CVD), coronary artery diseases (CAD), chronic obstructive pulmonary diseases (COPD), and lung cancer—account for 6- to 8-percent of all deaths in the Philippines. And these are just four of the many diseases caused by smoking, which harms nearly every organ of the body.

Since illness reduces worker productivity and premature deaths cut workers’ future income streams, the economic implications of smoking can be staggering. For the above smoking-related diseases, the DOH estimates the total economic costs as ranging from US$2.86 to USD$6.05 billion per year. These costs—calculating both healthcare costs and productivity losses, represent roughly 0.2 to 0.4 percent of the country’s GNP in 2003.

Worsening the situation is the fact that the tobacco industry particularly baits and hooks some of society’s most vulnerable sectors. The poor and the young, specifically, are most prone to succumb to the marketing and accessibility of tobacco products (cigarettes, most typically and almost universally, in the case of the Philippines.)

A 2006 DOH study found that smoking members of poor Filipino households can daily spend on cigarettes with as much money as can buy them an equivalent purchase of food worth 750 calories. That is more than a third of the national recommended daily allowance of 2,000 calories. Smoking, therefore, channels substantial resources away from basic needs and wiser investments needed to break away from poverty.

Among the youth, the Global Youth Tobacco Survey (GYTS) conducted by the WHO in 2004 indicates
that about 57 percent of current young smokers believe that smoking is “definitely harmful” to one’s health. And yet more and more Filipino youngsters continue to smoke—smoking incidence is accelerating among girls, in particular, though cigarette consumption among Filipino boys also continues to rise—draining their parents’ limited resources while reducing their own potentials and productivity as current or future members of the national workforce.

Meanwhile, there is now evidence that the flawed tax structures on tobacco may be costing the government in terms of lost potential collections from the industry. This in turn suggests that the country over the past decade may have lost billions of dollars what would have been earmarked funds for public health spending.

**Fixing flawed structures**

For tobacco tax increases to be an effective tobacco control mechanism, there is a need to revisit and reassert the values and objectives behind tobacco taxation. From there, it is vital to consider an alternative tax structure that can rectify the inefficacy of current systems.

As tobacco-control tools, the laws and tax structures on the Philippine tobacco industry need fixing. They are failing to reduce tobacco consumption, and worse, they are creating other problems. To be precise, an in-depth analysis of the current tax structures on tobacco suggest that they are:

- **strengthening a national tobacco oligopoly**—comprised of three major tobacco producers that control 99 percent of Philippine market. This oligopoly is in turn exploiting and undermining public policy through lobbies, political pressure, and outright corruption.
- **encouraging smokers to merely switch brands**, rather than quit smoking. Indeed, there is evidence that the flawed tax structures are actually encouraging more tobacco use.
- **distorting the real market prices of tobacco products, undervaluing the same** so as to lower actual tax contributions, and thus depriving government of lost potential revenue.
- **confusing the focus and objectives of tobacco taxation itself**. The current tax systems distract from what ostensibly is the ultimate value behind tobacco taxation, which is, supposedly, tobacco control as a public health measure.

*Values of an Industry, and the bias of current tobacco taxes*

To understand why such problems are arising, and to appreciate what must be done to rectify the situation, we must understand the history and context of the current laws on tobacco taxation. As we shall
see, the current tax structures have been politicized, corrupted, and distracted by the very industry they were conceived to control.

As already suggested above, tobacco tax structures in the Philippines appear to have been designed and implemented with the interests of an oligopoly highest in mind. A second value recognizes the potential contributions of the tobacco industry to national coffers by way of taxes, and then the supposed value of the industry to the national economy as a whole.

Public health interests, sadly, appears low among the intended benefits of the tax structures.

This must be turned on its head. Any review of current tax structures in light of tobacco control must have public health as its prime objective. Even national revenues and the national economy can only come second to the objective of saving lives and resources. And most certainly, the interests of the industry must come last.

Taxes on tobacco products in the Philippines

There are three major cigarette manufacturers in the Philippines: Fortune Tobacco Corporation (FTC), Philip Morris International (PMI), and La Suerte. These three companies have a combined market share of 99 percent. FTC dominates the industry with a 61 percent share of the market, and produces four of the top five brands, including the top two leaders, Champion and Fortune International. PMI comes in as a far second. With nearly the entire market controlled by an oligopoly, the three manufacturers easily control the market prices of cigarettes, and they have plainly influenced tobacco tax policy-making.

- **Fortune Tobacco Corporation**

- **Philip Morris**

- **La Suerte**
  - Brands: Aspen, Assos, Astro, Brixton, Fresno, Golden Key, Memphia

- **Others**

Source: ERC
Over the years, sections of the Tax Code have been amended several times to keep up with changes in the economy, including those pertaining to tobacco excise taxes. In the various versions of the law, tobacco excise taxes were either specific or ad valorem, but in a few cases, a combination of both types. Since 1997, a combination of ad valorem and multi-tiered specific tax structure has been in place. For cigarettes, excise taxes are multi-tiered specific.

There are two types of taxes imposed on locally manufactured tobacco products: an excise tax and a value added tax (VAT). For imported tobacco products, an additional import duty is imposed. The relevant tax laws that have been implemented on tobacco in the past ten years are the Tax Reform Code or Republic Act (RA) 8424 enacted in 1997 and in effect until 2004; and Republic Act 9334 – “An Act Increasing the Excise Tax Rates Imposed on Alcohol and Tobacco Products”.

RA 9334 is more popularly referred to as the “Sin Tax Law”, ostensibly because it is supposed to make the consumption of alcohol and tobacco products a more costly proposition.

In truth, however, tobacco taxes are structured in such a way as to not really discourage smoking. At best, they affect brand loyalty among current smokers, and at worst, they merely strengthen the existing dominant players in the tobacco industry. The taxes don’t the deliver desired effects of lower tobacco consumption precisely because they actually don’t follow the recommendations of the World Bank and WHO.

Consider the Sin Tax Law. A key aspect of the Sin Tax Law is that excise taxes are based on the net retail price (NRP) per pack of cigarettes. Crucially, however, the Sin Tax Law set the NRPs of all cigarette brands already existing in the Philippine market on or before October 1996. The law prescribed a fixed schedule of NRPs of these brands, programming a raise every two years beginning 2005 until 2011.

Only a Congressional bill can amend these scheduled price adjustments. At the same time, there is no provision in the law that adjusts NRPs for inflation.

One net result of this schedule and the non-factoring of inflation are artificially low retail prices for tobacco products. While NRPs are fixed by law, after all, the gross retail are market-determined. That is, manufacturers pass on their products at wholesale prices to retailers who in turn add the cost of distribution and mark-ups to determine the final (actual) gross retail price, or the price that smokers actually pay.

Because NRPs are fixed, the actual gross retail price tends to be lower than the theoretical gross retail price—or what should be the actual gross retail price had the NRPs factored in inflation and market forces, and not just legally predetermined prices.

In fact, analyses suggest that the actual NRPs of cigarette products should be 186 to 235 percent the NRPs currently assigned to them by the law. Had free market forces and inflation been allowed to determine actual NRPs, in fact, “low-priced” brands should by now have been reclassified to medium-priced, while the medium- and high-priced brands would by now have been reclassified to premium. Going by the upward re-categorization that should have taken place, the taxes on the products should also have been raised. Meanwhile, because actual gross retail prices increase while net retail prices remain fixed, the share of the sin tax to actual gross retail price is actually reduced.

In 2003, taxes as a share of gross retail prices were about 11-43 percent (depending on the cigarette type); with the stipulated tax increases in 2005, the tax share increased to 21-49 percent. If we adjust for market-determined NRPs, excise taxes would actually only be about 19 to 36 percent of the price that smokers actually pay. Whichever way one looks at it, tobacco tax in the country is considerably lower than the 65 percent share recommended by the World Bank.
In the economy, including those pertaining to tobacco excise taxes. In the various versions of the law, tobacco has had a combination of ad valorem and multi-tiered specific tax structure has been in place. For cigarettes, excise value added tax (VAT). For imported tobacco products, an additional import duty is imposed. The relevant tax laws that have been implemented on tobacco in the past ten years are the Tax Reform Code or Republic Act (RA) 8424 enacted in 1997 and in effect until 2004; and Republic Act 9334 – “An Act Increasing the Excise Tax Rates Imposed on Alcohol and Tobacco Products”.

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Crucially, however, the Sin Tax Law set the NRPs of all cigarette brands already existing in the Philippine market on or before October 1996. The law prescribed a fixed schedule of NRPs of these brands, programming a raise every two years beginning 2005 until 2011.

Note: Rates to increase by 6 percent every two years from Jan. 1, 2007 – Jan. 1, 2011.

### Tobacco Tax Regulations

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>i) Tobacco twisted by hand or reduced into a condition to be consumed</td>
<td>P0.75 per kilogram</td>
<td>P1 per kilogram</td>
</tr>
<tr>
<td>ii) Tobacco prepared/ partially prepared with/ without the use of any machine/ instruments</td>
<td></td>
<td>P1 per kilogram</td>
</tr>
<tr>
<td>iii) Fine-cut shorts, refuse, scraps, etc. of tobacco (provided these are to be exported or used in the manufacture of other tobacco products)</td>
<td>P0.60 per kilogram</td>
<td>P0.79 per kilogram</td>
</tr>
<tr>
<td>iv) Tobacco specially prepared for chewing so as to be unsuitable for use in any other manner</td>
<td>P0.60 per kilogram</td>
<td>P0.79 per kilogram</td>
</tr>
</tbody>
</table>

Note: Rates to increase by 6 percent every two years from Jan. 1, 2007 – Jan. 1, 2011.

### Cigars and Cigarettes

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>i) Cigars</td>
<td>P1 per cigar</td>
<td>P2 per pack beginning Jan. 2005</td>
</tr>
<tr>
<td>ii) Cigarettes packed by hand</td>
<td>P0.40 per pack</td>
<td>P2.23 per pack beginning Jan. 2007</td>
</tr>
<tr>
<td>iii) Cigarettes packed by machine (each pack with 20 pieces)</td>
<td></td>
<td>P2.47 per pack beginning Jan. 2009</td>
</tr>
<tr>
<td>for net retail price below P5 per pack</td>
<td>P1 per pack</td>
<td>P2.72 per pack beginning Jan. 2011</td>
</tr>
<tr>
<td>for net retail price of P5 to P6.50 per pack</td>
<td>P5 per pack</td>
<td>Note: each pack in thirty.</td>
</tr>
<tr>
<td>for net retail price above P6.50 to P10 per pack</td>
<td>P8 per pack</td>
<td></td>
</tr>
<tr>
<td>for net retail price of above P10 per pack</td>
<td>P12 per pack for net retail price of above P10</td>
<td>P25 per pack beginning Jan. 2005</td>
</tr>
</tbody>
</table>

Source: Adapted from DOH (2006).
There are two types of taxes imposed on locally manufactured tobacco products: an excise tax and a value added tax (VAT). For imported tobacco products, an additional import duty is imposed.

RA 9334 is more popularly referred to as the “Sin Tax Law”, ostensibly because it is supposed to make the consumption of alcohol and tobacco products a more costly proposition.

The relevant tax laws that have been implemented on tobacco in the past ten years are the Tax Reform Code or Republic Act (RA) 8424 enacted in 1997 and in effect until 2004; and Republic Act 10207, or the “Sin Tax Law” enacted in 2010.

A value added tax (VAT) is imposed on tobacco products. For imported tobacco products, an additional import duty is imposed.

The NRPs of tobacco products are determined by the Department of Trade and Industry (DTI). They are classified based on their NRP at the time of intended entry into the market, new products are effectively classified in higher product categories, and subject to higher tax brackets. Old brands, on the other hand, are quite secure in their assigned categories and brackets, precisely because the fixed NRP schedule keep their prices artificially low.

Economic simulations suggest that the fixed NRPs, because they are far too low relative to experts’ recommendations, diminish the effect of increased excise taxes in reducing cigarette consumption. Figures 12 and 13 illustrate this observation.

It is not just that the prices are artificially low. The categorization of tobacco products from low-to middle- to high-end prices are also illusory. In truth, the price spreads are so thin between categories, and the taxes so inconsequential, that when adjusted NRP-based taxes are imposed, smokers will tend to merely abandon their usual brands, and go for cheaper options. The bottomline, however, is that they will keep smoking.

The current tax structures will always allow for affordable cigarettes, in other words, not only because the taxes are programmed and programmed low, but also because tax rates fail to make any significant spread between low, medium, and premium categories of cigarettes. The lower-priced brands will always provide a fall-back option for smokers sensitive to price increases. They will not quit. They will merely switch brands.

Meanwhile, the government loses a substantial amount in excise tax revenues due to the misclassification of incumbent brands, and what then becomes uncompetitive classification of new brands. Because new brands are classified based on their NRP at the time of intended entry into the market, new products are effectively classified in higher product categories, and subject to higher tax brackets. Older brands, on the other hand, are quite secure in their assigned categories and brackets, precisely because the fixed NRP schedule keep their prices artificially low.

Ultimately, government is losing (revenue), and so are the people (on public health). The only sector that wins is the tobacco industry, or, to be more precise, the current dominant players in the tobacco industry.

It is important to abandon this current tax setup, and to come up with an alternative taxation scheme. Government must consider a substantial and fixed tax raise for all tobacco products, meeting the minimum 65 percent rate recommended by the World Bank, and applying this across all categories, while allowing for inflation and market forces to determine actual retail prices. When such adjustments are made, simulations show much more significant impacts of tobacco taxes on tobacco consumption.
What can be done?

For tobacco tax increases to be an effective control mechanism, there is a need to move towards an alternative tax structure.

Such a shift must start with policymakers re-stating and reaffirming the objective and logic behind tobacco taxation. To be precise, for tobacco taxation to have any chance of being effective as a control measure, it must explicitly have the public good as its highest value.

This may sound obvious, but given the history and current effects of existing policies, it is no trivial matter to revisit the premise behind tobacco tax structures. The fact is that current tobacco taxation is distracted by two other values: that which emphasize the tax contributions of the tobacco industry to national coffers for one, and that which is mindful of the tobacco industry’s supposed contributions to the national economy for the other.

While much has been said and written about how tobacco taxation can curb demand for tobacco while *simultaneously* raising government revenues, the former benefit must be emphasized and prioritized over the prospect of the latter. Taxation for tobacco must only incidentally be appreciated for potential impacts on government revenue.

This is important because, as we shall further discuss, evidence suggests that when it comes to the twin benefits of lower smoking incidence and higher government revenue, things can get complicated in the Philippines. So a value statement is most crucial: Policymakers must recognize that the ultimate goal of raising tobacco taxes is to reduce tobacco consumption.

After reasserting the primacy and value of public health interests over economic considerations, any attempt to improve legislation on tobacco tax structures must be evidence-based.

It is precisely in this need that the findings of one of the most thorough studies on tobacco use and taxation in the Philippines is presented in this publication. That study—carried out by Quimbo et al (“The Economics of Tobacco and Tobacco Taxation in the Philippines”), under the auspices of World Health Organization and commissioned by the Bloomberg Global Initiative to Reduce Tobacco Use revisited all premises to the discussions about tobacco consumption and tobacco taxation, proceeded again from the following questions:

- Can increased taxes curb smoking?
- Can it reduce the cigarette consumption of the young Filipinos?
- Will increased taxes increase government revenues?
- What do tobacco taxes—as currently implemented and as proposed—mean for the poor?
- How can the current laws on tobacco control be further improved?

What follows are findings and recommendations of that study, for consideration by the country’s policymakers, legislators, and leaders.
Can increased taxes curb smoking?

Yes. Global evidence is overwhelming, and the link between higher taxes and lower smoking incidence is accepted and endorsed by both the World Bank and the WHO.

What is more important to stress now, however, is that such tax increases must have minimum levels to be effective. The World Bank recommends a minimum rate of 65 percent to achieve a tobacco consumption reduction of up to 8 percent.

With the current tax structure in the Philippines, however, the effect is not as much as advocates would hope. The impact on cigarette consumption of tax increases as stipulated by the current law is likely to be modest. While global evidence has suggested that a 10 percent increase in tobacco taxes was associated with an 8 percent reduction in consumption, simulations based on Philippine tax rates show that with a 10 percent increase in taxes, the predicted declines in consumption would generally be below 4 percent.

Because the current tax structure in the Philippines does not meet the World Bank’s recommended minimum standards, the structure is a weak tool for tobacco control. A 10 percent increase in excise taxes under the current structure is predicted to reduce consumption by less than 1 percent for the cheapest and premium brands, and less than 3 percent for the intermediate brands. Ultimately, it may merely be inducing smokers to switch to lower-priced brands, while, at that, actually strengthening the dominant players in the tobacco industry.

The Philippines ranked 5th in the world in adult male smoking prevalence in 2003: Some 57.6 percent of males 15 years and older were current tobacco users—daily and occasional smokers of cigarettes, cigars, pipes or any other smoked tobacco products [World Health Organization (WHO)]. Among adult females, the Philippines ranked 26th with a smoking prevalence rate of 12.3 percent. Among members of ASEAN (Association of Southeast Asian Nations), the Philippines has the second biggest proportion of adult smokers at 16.6 percent [Southeast Asia Tobacco Control Alliance (SEATCA) 2007]. Smoking prevalence among the youth (aged 13–15) was ranked 12th in the world in 2004, with a current tobacco use prevalence of 15.9 percent.
Can it reduce the cigarette consumption of young Filipinos?

Yes.

Youth demand for cigarettes differs significantly from adult demand. Put plainly, their purchasing powers and habits are different.

For instance, it seems prices do not determine a young person’s decision on whether or not to start smoking. Peer pressure and whether or not his or her parents are smokers are better predictors of whether or not a young individual will experiment with cigarettes. The poor and the young are the main markets of tobacco products precisely because they are myopic, or short-sighted, and information campaigns by themselves cannot completely influence their behaviour. The Global Youth Tobacco Survey (GYTS) conducted in 2004 indicates that about 57 percent of current youth smokers believe that smoking is “definitely harmful” to one’s health, yet continue to smoke.

Once a young individual has taken up the habit of smoking, however, consumption levels are highly sensitive to price changes. So a young person may start experimenting, and may get addicted, regardless of price, but once he or she is a habitual user, the amount of cigarettes he or she consumes will be affected by the price of cigarettes. In other words, he or she will disregard affordability at the start, but a young individual will not necessarily be able to sustain the habit if cigarette prices were to go up significantly.

Of course, non-tax interventions are still important to continue. Again, given the peculiar thinking and means of young individuals—given to peer pressure and also a tendency to “bum” (or to have access to free cigarettes from friends or relatives)—it is important to keep them aware of the harms of tobacco use. They will acknowledge the information and be mindful of it, making them what economists call “rational addicts”. Economists note that two ways to reduce the consumption of a rational addict is to raise the monetary price of the object of his or her addiction, or, through increased information, emphasize its harmful effects on his or her future.

Since illness reduces worker productivity and premature deaths cut workers’ future income streams, the economic implications of smoking are potentially substantial. For these four smoking-related diseases, the total annual economic costs range from US$2.86 to USD$6.05 billion [DOH 2006]. These costs, which comprise both health care costs and productivity losses, represent roughly 0.2 to 0.4 percent of the country’s GNP in 2003.
Will increased taxes increase government revenues, or will a higher burden on the tobacco industry be detrimental to the economy?

An additional benefit from tobacco tax increases is the potential expansion of government revenues. Using data from 70 countries, one study estimates that the revenue generation potential of tax increases is large: a 10 percent increase in tobacco taxes would increase tax revenues by close to 7 percent.

But simulations using current policies in the Philippines suggest that the rate of increase will be affected if the most effective tax structures to reduce tobacco control are pursued.

To be clear: revenues will rise no matter the model, but the existing structures, subject to tax increases, would be more advantageous in revenue terms than the expected gains using an adjusted model.

In this choice, a clear value for public health is vital to having the political will for passing a more effective tax policy on tobacco products.

As for the tobacco industry’s supposed “importance” to the overall Philippine economy, evidence is now available to completely discredit the argument of tobacco’s indispensability.

Cigarette manufacturers have argued that a reduction in cigarette consumption would result in significant permanent job losses, especially in the tobacco farming and manufacturing sectors. While it is true that employment in said sectors will decline, the net effect on the macroeconomy is likely to be minimal.

For one, it’s likely that money spent on tobacco consumption would simply shift to other goods and services.

A decrease in tobacco consumption brought about by an increase in excise taxes will mostly affect employment only in the tobacco manufacturing. This sector had little more than 10,000 employees in 1999.

Beyond the tobacco industry itself, tobacco manufacturing is dependent on 31 other sectors. The sector with the biggest inputs to the tobacco industry is itself (tobacco manufacturing sector), with a contribution of 30 percent of intermediate inputs. This is followed by the paper and paper products sector at 22 percent, and then by the trade sector which contributes 14 percent. The fourth and fifth contributors are the chemical and chemical products sector (13.65 percent), and the other crops and agricultural services sector (8.1 percent), respectively.
The Economics of Tobacco and Tobacco Taxation (Philippines)

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A detailed analysis of the input-output table for the tobacco industry reveals that it is dependent on 32 sectors. The sector with the biggest inputs to the tobacco industry is itself (tobacco manufactures sector), with a contribution of 30 percent of intermediate. This is followed by the paper and paper products sector at 22 percent, and then by the trade sector which contributes 14 percent. The fourth and fifth contributors are the chemical and chemical products sector (13.65 percent), and the other crops and agricultural services sector (8.1 percent), respectively.

### Top Five Sectors with the Largest Share of Intermediate Inputs to the Tobacco Industry, 2000

<table>
<thead>
<tr>
<th>Industry</th>
<th>Intermediate Inputs Supplied (PhP)</th>
<th>% of Total Intermediate Inputs</th>
<th>Total Output (PhP)</th>
<th>% of Intermediate Inputs to Total Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tobacco manufactures</td>
<td>5,821,258</td>
<td>30.08</td>
<td>40,000,590</td>
<td>14.55</td>
</tr>
<tr>
<td>Paper and paper products</td>
<td>4,312,909</td>
<td>22.29</td>
<td>52,662,012</td>
<td>8.19</td>
</tr>
<tr>
<td>Trade</td>
<td>2,834,018</td>
<td>14.64</td>
<td>863,518,600</td>
<td>0.35</td>
</tr>
<tr>
<td>Chemical and chemical products</td>
<td>2,640,967</td>
<td>13.65</td>
<td>210,093,985</td>
<td>1.26</td>
</tr>
<tr>
<td>Other crops and agricultural services</td>
<td>1,568,423</td>
<td>8.10</td>
<td>137,199,778</td>
<td>1.14</td>
</tr>
<tr>
<td>Total, Top 5 Sectors</td>
<td>17,177,576</td>
<td>88.77</td>
<td>7,520,612,523</td>
<td></td>
</tr>
<tr>
<td>Total Intermediate Inputs</td>
<td>19,351,604</td>
<td>100.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Primary Inputs</td>
<td>20,648,986</td>
<td></td>
<td>4,157,016,141</td>
<td></td>
</tr>
<tr>
<td>Total Inputs</td>
<td>40,000,590</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Although the inputs of these five sectors to the tobacco industry seem to be substantial, the proportion which they contribute to the tobacco industry relative to their own industry's total output is very minimal. The tobacco manufactures sector's contribution to the tobacco industry is only 14.55 percent of its total output. The paper and paper products sector's contribution is 8.19 percent and the trade sector's P2.83-billion input is a mere 0.35 percent of its total output. The other crops and agricultural services sector's P1.57 billion input is only 1.14 percent of its total output. The chemical and chemical products sector contributes no more than 1.26 percent of its total output to the tobacco industry. Hence, the losses to these industries would be minimal should there be any decline in the production volumes of the tobacco manufacturing sector.
Tobacco’s drain on household resources is actually magnified for poorer families. The poorest 20 percent (quintile 1) of the population spend 2.8 percent of their income on tobacco products, while the richest 20 percent spend only 0.8 percent.

**Tobacco taxes: What does it mean for the poor?**

In the Philippines, the debate around tobacco taxation has primarily revolved around whether the appropriate excise tax is an ad valorem or a specific tax. An ad valorem tax is determined as a percentage of selling price. A specific tax, on the other hand, provides level of tax that is fixed independent of the value of the item being purchased.

Since 1997, a combination of ad valorem and multi-tiered specific tax structure has been in place.

The criticism against excise taxation is that it is seen to be unfair to poorer people who can only afford lower cost items, which are still taxed by the same amount. To mitigate against this effect, cigarettes in the Philippines (which account for 99 percent of all tobacco products consumed in the country) are categorized according to price, and fixed rates are applied depending on the categories.

This current tax structure is marginally progressive. That is, it collects on richer smokers more than it does on the poor. One truth to a high uniform specific tax, on the other hand, is that it would be marginally regressive. That is, the increases in taxes would impact on poor smokers more than the rich.

While the current law does have a mechanism for re-distribution of tax revenues to benefit poor households—such as earmarking of taxes for the tobacco industry, the Department of Health’s disease prevention programs, and the PhilHealth’s coverage of indigent households—it has not been implemented. To date, the executive department has reportedly not remitted an estimated P300 million in funds earmarked for public health services; this cumulative amount represents the revenue gains from the imposition of the highly unpopular expanded value-added tax (e-VAT) and the sin taxes.

A shift to a uniform tax should therefore require more serious implementation of tax earmarking, because the poor will indeed be paying more taxes on their cigarettes relative to richer smokers.
Furthermore, it’s worth noting that the most dominant form of health care payment is out-of-pocket spending by households. Social insurance payments account for less than 10 percent of total spending. This therefore weakens the argument that a corrective tax can effectively address the inequitable passing of the health care spending burden from smokers to non-smokers.

Having acknowledged the regressive nature of a uniform specific tax, however, government must assert the value statement behind any tobacco taxation program. That is, the economic argument for a corrective tax hinges precisely on the need to reduce tobacco consumption, especially by the poor and the youth.

As asserted earlier, only by clarifying and making explicit the ultimate social objectives of tobacco taxation can the country’s policymakers move unequivocally on reforming the tobacco tax structure. They must remind themselves that higher taxes will compel more people to quit smoking, and the poor in particular will save more resources and be compelled to use the same more wisely.

Indeed, the regressive nature of a uniform fixed tax in this case is in the context of cigarettes. The ultimate impact is not on tax collections, and the ultimate question is not where the bulk of it will come from. Rather, the impact will be felt in healthier people, and the ultimate question will be how the revenues will be used to further the cause of public health.

**Distribution of Monthly Expenditures for Poor Households, 2003**

For poor households, tobacco’s share of household expenditures is even more than that for education, and is comparable to health and education combined. Poor households’ spending on tobacco is 2.6 percent of total expenditures while that for education and health combined amounts to only 2.9 percent.

Source: DOH (2006)
How can the current laws on tobacco control be further improved?

Policymakers should view tobacco taxation as primarily a public health intervention and only secondarily a public finance intervention. By this, the government should have no dilemma about moving away from a multi-level specific tax to a high uniform specific tax would make sense.

Moving to an alternative tax scheme where a high uniform specific tax would be imposed on all brands could sharply reduce cigarette consumption. Simulations indicate with high-enough rate, a single specific tax would consistently reduce consumption of cigarettes across all types.

A high uniform tax of at least P15 would be more effective in terms of reducing consumption. The option of switching to cheaper brands would be negated, such that smokers will find it more compelling to quit their habit altogether.

Simulations make it clear that moving to an alternative tax scheme where a high uniform specific tax would be imposed on all brands could sharply reduce cigarette consumption. Even with the switching assumption, a single specific tax would consistently reduce consumption of cigarettes across all types.

Tax increases under the current tax structure are not only weak measures but could in fact be counterproductive as it encourages consumption of cheaper brands. The tax increase has to be very large to make a large impact (both on the consumption of the existing smokers and the number of new smokers). We have shown that a high uniform tax of at least P15 would be more effective in terms of reducing consumption. The option of switching to cheaper brands would be negated, such that smokers will find it more compelling to quit their habit altogether.

Product Substitutability Induced by Price Gaps

The current tax structure induces a large price gap between tobacco products, allowing smokers to switch to lower-priced brands once the price of the brand they smoke is increased by a substantial rate. The figure below illustrates the price gaps among low-, medium-, and high-priced locally manufactured cigarettes. Since the base for both excise and value-added taxes is the net retail price, and both taxes increase as the net retail price increases, the price differences among the three groups then becomes larger. Therefore, the scope for product substitution is also large, i.e., if a smoker prefers a high-priced brand, an excise tax increase may induce him to switch to a medium-priced brand. Hence, if the aim of tobacco tax policy is to be shifted from revenue generation to curbing the increasing smoking prevalence, then the tax structure would have to be one that raises the market prices of all tobacco products and brands substantially such that smokers are more likely to quit than switch to another brand.
Furthermore, the argument for a uniform specific tax is bolstered in the Philippine context because it would reduce the likelihood of regulatory capture—or corruption and susceptibility in the system. An important weakness in the current tax structure is that tax increases even if not nominally low, might become effectively low presumably as a result of lobbying.

As illustrated and explained earlier, actual net retail prices for selected brands were too low, at least in theory or according to the law’s definition of net retail price vis-à-vis gross selling price. Net retail prices were also fixed over time and thus unaffected by inflation. Since net retail prices became the bases for tax rates, selected firms, i.e., incumbent firms at the time the law was passed, were arguably taxed inappropriately low tax rates.

Put differently, under the current tax structure, the average tax rates could be easily dampened by the successful lobbying of firms to have their brands classified at the lowest possible tax bracket. While it is difficult to predict how the tobacco lobby would respond to a major change such as moving to a uniform specific tax, policymakers and government implementors should expect this type of lobbying (for cigarette classification) to become obsolete. At the very least, under a considerably simpler tax scheme, lobbying efforts might become more apparent and possibly, more costly.

For example, recent evidence shows that the Department of Finance (DOF) seems to be favoring a uniform specific tax, precisely because they see advantages from an administrative efficiency standpoint. Specific taxation would, after all, make tax evasion more difficult as production volumes are more difficult to dispute compared to selling prices.
Finally, it must be stressed that tobacco control cannot only rely on taxation. Even the best thought-out and well implemented taxation scheme will not completely defeat the health and social costs of smoking.

It must be noted that the most effective non-tax control measures are those that are school-based, in light of the finding that the smoking status of close friends and classroom lessons on the health risks of smoking are important factors influencing youth smoking participation. Third, policymakers should recognize that the need to reduce adult cigarette consumption becomes even greater when intergenerational aspects of smoking are considered. The smoking participation among the young was strongly predicted by the smoking status of their parents.

In this light, improving the taxation system so as to reduce tobacco consumption across all demographics will be self-reinforcing, more sustainable, and have immediate as well as long-term benefits to the Philippines.

For tobacco tax increases to be an effective control mechanism, there is a need to move towards an alternative tax structure. Tax increases under the current tax structure are not only weak measures but could in fact be counter-productive as it encourages consumption of cheaper brands. The tax increase has to be very large to make a large impact (both on the consumption of the existing smokers and the number of new smokers). Simulations show that a high uniform specific tax could make a difference.