



Budget 2008 : Tobacco tax submission

ASH

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Introduction

1. This paper gives views on tobacco policy in tax and related areas in advance of the forthcoming Budget, supported by the organisations listed on the front page of this document.
2. This Government is to be congratulated on the range of policies it has successfully implemented to drive down smoking prevalence since the publication of the seminal white paper, *Smoking Kills*, in 1998. Indeed it has very recently been announced that smoking rates in England have fallen from 28 per cent in 1998 to 22 per cent in 2006 with a reduction in smoking amongst routine and manual workers of 33 to 28 percentage points, with a similar picture across the UK.¹ This illustrates just how effective tobacco control can be as a strategy for reducing smoking prevalence and improving public health. However, the differential in smoking rates between manual and non-manual workers over this time has not been eroded.
3. Smoking is the cause of over half the difference in life expectancy between social class 1 and 5, and death rates from tobacco are two to three times higher among disadvantaged social groups than among the better off. Therefore further measures to reduce smoking, targeted at the most disadvantaged in society, are essential if health inequalities are to be reduced, a priority for this government. The Government has taken this on board and recently announced that it would be consulting on a new tobacco control strategy in the Spring.² We urge the Government to use this opportunity to build on past successes with a new and adequately resourced, comprehensive, cross-governmental strategy for tobacco control.
4. Tobacco tax is strongly regressive and for those smokers who don't quit it can increase health inequalities, particularly for less affluent smokers. On the other hand, genuine price increases do help lead some smokers to quit and make very substantial health and welfare gains for those that do quit. This poses a

¹ Smoking and drinking among adults, 2006. General Household Survey 2006. www.statistics.gov.uk

² Cancer Reform Strategy. Department of Health. 3 December 2007.
<http://www.dh.gov.uk/en/Policyandguidance/Healthandsocialcaretopics/Cancer/index.htm>

dilemma, which we believe can be resolved only by making the greatest possible efforts to motivate and assist smokers to quit in response to increases in taxation.

5. We believe therefore that action to help smokers quit is intimately connected to the policy of raising taxes from them, and that there is a strong, rational case for maintaining and sustaining a high level of investment in tobacco control measures and to target specifically the most disadvantaged smokers. This should be in addition to broader Government strategies to reduce deprivation and income inequality.

Summary of recommendations

Tax rates in the Budget

- 1) There is some evidence that the reduction in VAT on smoking cessation products from 17.5% to 5% has reduced prices and had a positive impact on sales and should therefore be sustained permanently.
- 2) After six years of the Tackling Tobacco Smuggling strategy and following significant falls in tobacco smuggling we believe the time has come to consider raising tobacco taxes above the rate of inflation in this Budget.
 - We recommend that a real price escalator of 3% above inflation should be reintroduced.
 - Increases should be on the specific tax element as far as possible to ensure that the price of the cheapest tobacco is increased proportionately more than that of higher priced brands, so discouraging trading down.
 - Hand-Rolled Tobacco – the tax rate should be increased at least in line with cigarettes, to discourage trading down.
 - Cigars - increases should also be kept in line with cigarettes.

Smuggling

- 3) Specific PSA targets for smuggling expire at the end of this financial year. We urge the Treasury to ensure that HMRC continue to set, publish and monitor targets under its Departmental Strategic Objectives for reducing the market share both of smuggled cigarettes and handrolled tobacco in the UK.
- 4) Furthermore with the integration of customs officers into the new UK Border Agency later this year it is crucial that responsibility for meeting targets in reducing the illicit trade in smuggled tobacco (as well as other relevant targets) become a shared responsibility with the new Agency.
- 5) We are pleased that the UK supports the development of an illicit trade protocol to the Framework Convention for Tobacco Control (FCTC) to be negotiated and brought into force as quickly as possible. We would like the UK to also make clear that it supports the strongest possible protocol along the lines of the template developed by the WHO expert working group.
- 6) We welcome the Hand-Rolled Tobacco strategy (HRT). However, the implementation of controls on sales of HRT to end markets to ensure they are not oversupplied is crucial to the success of this strategy and must be implemented urgently, with end market size being determined independently by HMRC.
- 7) The UK should sign up to the Agreements between the EC/26 Member States and the two tobacco companies, Philip Morris International (PMI) and Japan Tobacco International (JTI).

Review of EU tax directive 2002/10/EC

- 8) We support the recommendations the UK has made in response to the consultation about how the EU directive 2002/10/EC should be revised.

Market reporting and evaluation

- 9) There should be an annual report on the tobacco market detailing its structure, price variations within categories, calculated price-elasticities, consumption patterns by socio-economic group, age and other demographics, market share by brand etc.

Counteracting misunderstandings about health consequences of counterfeit products

- 10) While counterfeit cigarettes may contain higher levels of certain toxins, there is no evidence that they are more deadly than legally manufactured cigarettes. Publicity to the contrary risks implying to smokers that tobacco industry manufactured cigarettes are less deadly than counterfeit cigarettes. We would urge HMRC and HM Treasury to remove all references to increased risk from counterfeit cigarettes from their publicly available materials and to ensure that no further reference to increased health risk of counterfeit cigarettes is made by HM Treasury or HM Revenue and Customs and that if any such reference from the past is picked up by the media it is immediately corrected.

Tax rates in the budget

Tax on Nicotine Replacement Therapy (NRT)

6. ASH commissioned an independent marketing consultant to carry out a review of changes in pricing and sales volumes of NRT following the reduction in VAT from 17.5% to 5% introduced at the time of the implementation of smokefree legislation on 1 July 2007. A copy of this report is included with this submission, which has also been supplied to the Department of Health.
7. There was a decline in unit price between July 2006 and November 2007 of 16%, significantly higher than the 10.6% accounted for by the decline in VAT. It is not believed that this was due to a significant change in the sales mix over this period.
8. It is more difficult to carry out an analysis of the impact of the price reduction on sales as there are confounding factors due to the implementation of the legislation, and promotional activity around its implementation both for products themselves and the need to quit and for the legislation. However, there was a significant increase in sales over the period.
9. The implication, therefore, is that the tax cut was passed on to consumers and resulted in increased sales of NRT. This implies that the tax cut had the effect that was wanted and that the Treasury should maintain this tax cut long-term.
10. It would be useful to carry out a controlled piece of research looking at the price elasticity of NRT, in order to test more specifically the impact of price changes on sales.

Tobacco Tax

11. We remain firmly in favour of using price as a means of reducing tobacco consumption, an approach recognised by both the World Bank and World Health

Organisation as an economically rational plank of public health policy. We believe that the prices paid by smokers should rise *ahead of the rate of growth in incomes* so as to stop tobacco becoming more 'affordable' (the policy outlined in the 1998 tobacco White Paper, *Smoking Kills*³). Cigarettes in the UK were 60% more affordable in 1997 than in 1965, and since the Government stopped increasing tobacco tax by more than inflation in 2001, cigarettes have continued to become more affordable year on year, a trend that has been exacerbated by downtrading to cheaper cigarettes and HRT, and smuggling.

12. Raising prices also helps to reinforce the introduction of other strategies. An econometric analysis of the decline in consumption in cigarettes in California between 1990 and 1992 estimated that while the media campaign was important, 78% of the decline was attributable to tax increases and 22% to the media campaign.⁴
13. This was shown to be the case in Ireland. Ireland increased cigarette tax by 25 cents in December 2003, 2% above inflation, shortly before the introduction of smokefree legislation in March 2004. In the first year after the legislation came in smoking prevalence fell 2.5%. In 2006 after the December 2005 budget when tobacco tax was left unchanged, smoking prevalence then stabilised and began to rise again.⁵
14. Tobacco price elasticity is estimated by the World Bank⁶ to be around -0.4 for developed countries, which means that a 10% rise in price leads to a 4% decline in consumption, but it has tended to be higher in developing than developed countries⁷, and also higher among lower-income smokers⁸, and younger smokers. In the UK the current long run estimate is that price elasticity is around 0.72, taking into account the smuggled market.⁹
15. A real price escalator on top of inflation of 3% should be reintroduced, which we estimate would add 10 pence above inflation to a packet of premium priced cigarettes. Real price tax increases are supported by a majority of public opinion¹⁰, and an increase of this level is supported by the majority of the population. This includes a majority of smokers who would support price increases if they were used to help stop young people take up smoking and help smokers quit.¹¹

³ Department of Health. *Smoking Kills. A White Paper on tobacco*. London: The Stationery Office, 1998.

⁴ Hu T-W, Sung H-Y, Keeler TE. Reducing cigarette consumption in California: tobacco taxes vs. an antismoking media campaign. *Am J Public Health* 1995b;85(9):1218-22

⁵ Fell, Jonathan. *Irish Resilience Suggests Moderate UK Impact*. Morgan Stanley Equity Research Europe. October 11, 2005.

⁶ *Curbing the Epidemic: Governments and the Economics of Tobacco Control*. World Bank, 1999.

⁷ Jha P, Chaloupka FJ. *Curbing the Epidemic: Governments and the Economics of Tobacco Control*. Washington DC: World Bank, 1999.

⁸ Wilson N, Thomson G. Tobacco tax as a health protecting policy: a brief review of the New Zealand evidence. *N Z Med J* 2005;118(1213):U1403

⁹ Cullum P HM Customs & Excise and Pissarides, C LSE. *The Demand for Tobacco Products in the UK*. Government Economic Service Working Paper No. 150. December 2004. HM Customs & Excise.

¹⁰ *Smoking-related behaviour and attitudes, 2005*. Office for National Statistics, London, 2006.

¹¹ West R (2006) *Public support for a tobacco levy*.
www.smokinginengland.info/Ref/paper5.pdf

Tobacco Smuggling

16. Specific PSA targets for smuggling expire at the end of this financial year. We urge the Treasury to ensure that HMRC continue to set, publish and monitor targets under its Departmental Strategic Objectives for reducing the market share both of smuggled cigarettes and handrolled tobacco in the UK. These should be for the CSR 2007 period and thereafter.
17. In principle the integration of customs officers into the new UK Border Agency should as Government expects, *“improve our ability to detect terrorism and crime, while encouraging the flows of people and trade on which our future as a global hub depends.”*¹² However, if our ability to drive down the prevalence of illicit trade in tobacco and thereby increase tobacco tax revenue is not to be undermined, it is crucial that responsibility for meeting these targets become a shared responsibility between HMRC and the new Agency. There do not appear to be recommendations relating to shared targets included in the Cabinet office document setting out the remit of this new organisation and this needs to be made explicit.¹³ Merely having a single responsible Minister will not ensure that the new Border Agency sees reducing smuggling, and thereby increasing tax revenue, as a key goal.
18. We would also like to seek assurance from HMRC that the current level of inland tobacco enforcement work will continue following the merger of the relevant team into the new Cross Border Agency.

FCTC Protocol on illicit trade in tobacco

19. We are pleased that the UK Government supports an illicit trade protocol to the Framework Convention on Tobacco Control and that HMRC is participating actively in the process for developing an EU position, based on the template developed by the WHO expert working group on illicit trade.
20. The template includes a comprehensive set of measures which would commit Parties to the FCTC to act domestically and internationally to tackle this trade. Measures set out in the template include:
 - Marking of tobacco products so they can be tracked and traced from manufacture to point of sale and illicit products, including counterfeit, can be identified.¹⁴ This would also help determine the point of diversion from the legal to the illicit market.
 - Licensing of participants within the supply chain would ensure they could be monitored effectively and that they would risk losing their licence if they were found to be dealing in illicit products.
 - Obligations on manufacturers to control the supply chain for their products, with serious financial penalties for those that fail to do so.

¹² Security in a Global Hub. Establishing the UK’s new border arrangements. Foreword by the Prime Minister. Cabinet Office. November 2007

¹³ Security in a Global Hub. Establishing the UK’s new border arrangements. Summary p.5-19. Cabinet Office. November 2007

¹⁴ “Tracking” refers to the ability of competent authorities to systematically monitor the movement of tobacco products from the place of manufacture, through the distribution chain, to the intended market of retail sale, making sure all relevant duties and taxes have been paid. “Tracing” refers to the ability of competent authorities, on the occasion of an audit or a seizure of a genuine product, to recreate the route taken by a tobacco product from the place of manufacture, through the distribution chain, to the point where the product has been diverted into illegal trade channels.

- Enhanced law enforcement measures such as cooperation in investigation and prosecution of offences, information sharing, mutual legal assistance and extradition arrangements, which would improve the ability of governments to work effectively together to overcome the illicit trade.

21. Under Article 5.3 of the Framework Convention on Tobacco Control the tobacco industry is excluded from involvement in the development of the Treaty and its protocols. This is because this is an industry that has fought for many years to undermine tobacco control, as industry documents uncovered through litigation in the US have revealed. BAT, in particular, fought to block the development of the FCTC, and has campaigned to try to discredit research from WHO.¹⁵ Negotiations are currently taking place on guidelines for Article 5.3 and it would benefit HMRC to monitor these developments as they will impact on the process for developing the illicit trade protocol.
22. The Government of the United Kingdom has played a key role in getting this protocol underway. All the measures that a strong protocol will include will help tackle illicit trade in counterfeit as well as genuine product. We look forward to seeing the UK support the adoption of the strongest possible protocol, a global solution to a global problem.

EU Agreements

23. The UK has refused to sign the EU Agreement with Philip Morris International (PMI) citing to ASH reasons such as that: Philip Morris is a small participant in the UK market; that the Agreement is incompatible with the Finance Act legislation; and that the Agreement does not add value to the MOUs the UK government has with manufacturers.
24. We believe that in the light of the new Agreement with Japan Tobacco International the Government should reconsider urgently whether it should become a signatory.
25. The argument that the Agreement relates only to a small player in the market no longer applies, as JTI owns the second biggest player in the UK market, Gallaher, with just under 40% UK market share. Gallaher will fully join up to the Agreement in two years, but the general compliance obligations apply immediately.
26. The argument that the Agreement is incompatible with the Finance Act legislation does not apply to either the PMI or the JTI Agreement. The exemption from litigation in the Agreements only applies to civil litigation relating to conduct prior to the signature date and that was covered by the US litigation, not to any other conduct prior or post the dates the Agreements were signed. In other words the Agreements do not exempt the companies or their employees from any criminal, tax, administrative, or healthcare claims relating to conduct that took place before the Agreements were signed or for any liability relating to conduct taking place after the signing of the Agreements. The Agreements do not therefore limit in any way the proper law enforcement powers of the EC or signatory Member States.

¹⁵ BAT in its own words 2005: the alternative British American Tobacco social report. Published by ASH, Christian Aid and Friends of the Earth. London April 2005.

27. The key features of the Agreements are: seizure payments by the two manufacturers if any of their products are smuggled in the EU; compliance protocols, requiring the manufacturers to control the contractors it supplies with cigarettes and to stop supplying them if they are found complicit in smuggling; tracking and tracing protocols giving customs 24 hour online access to the database, allowing customs to independently identify smuggled cigarettes so they can be traced back to the contractor who bought them from the two manufacturers. The Agreement is reviewed annually, has a full audit and performance review process built into it, and an independent arbitration process.
28. Even if the only added value were the seizure payments, these Agreements are worth signing. The UK can do this at no cost and would benefit financially. In its evidence to the National Audit Office, HMRC admitted that the UK would have benefited in 2003-4, but by 'less than £1 million'.¹⁶ However, what about financial gains from the Agreement in the three years since then, and for the future, which have been foregone by not signing up to the Agreement?¹⁷
29. When it comes to JTI the case for signing is even stronger. In 2005-6 some 200 million of the 2 billion smuggled cigarettes seized by HMRC were made by Gallaher, making them the UK brand with the biggest share of the smuggled market. Had the UK been a signatory and the JTI Agreement fully in force at that time the UK would have been due over £100 million in seizure payments from Gallaher.¹⁸ The Agreement provides the strongest possible incentive to the manufacturer not to facilitate smuggling of its product into the UK.
30. In conclusion, we believe the UK would benefit from signing the JTI and PMI Agreements and we recommend that this be done as soon as possible.

Handrolled Tobacco

31. The new strategy for controlling smuggling of HRT is crucial, given an illicit market share far higher than cigarettes, estimated to be between 53% and 64% for 2004-5.¹⁹ For the first time manufacturers are expected to control the sales of HRT to end markets so that only sufficient product to supply that market will be sold. This will be a major lever to reduce smuggling of this product given that smuggled HRT is primarily UK-produced product exported to Benelux countries where tax is far lower and re-imported by smugglers into the UK.
32. However, 26 months later it is still not clear whether this provision has been adequately implemented. This measure is crucial to the success of the Hand-Rolled Tobacco anti-smuggling strategy and must be implemented urgently.

¹⁶ Comptroller and Auditor General's Standard Report on the Accounts of HM Customs and Excise 2004-5. 7 October 2005. p.19. http://www.nao.org.uk/publications/nao_reports/05-06/0506447.pdf

¹⁷ Between the implementation of the PMI agreement and the end of June 2007, more than 1000 seizures of PMI cigarettes were reported, totalling over 900 million cigarettes, with about 80% of these cigarettes found to be counterfeit.¹⁷ Around 180 million seized PMI cigarettes led to seizure payments.

¹⁸ This is based on HMRC estimates that in 2005-6 2 billion cigarettes were seized of which 18% were made by UK tobacco manufacturers. Gallaher brands accounted for 49% of that 18% (i.e. around 9% of the total). The tax per packet at that time was £3.91, and 100% of the tax and duties was owed on the first 90 million and 500% thereafter, making a total of over £100 million.

¹⁹ HM Revenue & Customs. Annual Report 2005-6 and Autumn Performance Report 2006. Presented to Parliament by the Paymaster General by Command of Her Majesty. December 2006.

Review of EU tax directive 2002/10/EC

33. We support the position set out in the UK's response to the EU consultation on the tax directive. We are pleased to note that the UK and nearly all other Member States have ratified the FCTC and therefore *"recognize that price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons."*²⁰
34. We are particularly pleased to see the recommendations that:
- The Most Popular Price Category should be abolished and that EU requirements should apply to all cigarettes.
 - Only specific duty should be applied to cigarettes and other tobacco products, as ad valorem taxes undermine public health policy, while specific duties ensure equal taxation of all cigarettes.
 - The 55% limit on specific duties be abolished.
 - The minimum incidence of 64 euros per 1000 cigarettes should be raised to the greatest possible extent.
 - Only specific duties should be levied on fine cut tobacco and that there should be an alignment in taxation of HRT, but only upwards.
 - Minimum rates for handrolled tobacco (HRT) should be increased.
 - VAT should not be included in the minimum incidence as it could lead to an effective reduction in the minimum rate.

Market reporting and evaluation

35. In his 2004 report to HM Treasury, Wanless recommended that *"A commitment of adequate resources for monitoring and feedback should be an integral part of the planning of any national programme to tackle the key determinants of health. (Paragraph 3.97)"*
36. We continue to support this recommendation. Tobacco taxation is an important health and fiscal policy, yet very little data are published about the structure of this £10 billion tax base and the response of consumers to changes in tax rates and other changes in policy such as legislative changes. There are data in the General Household Survey, Consumers' Expenditure Survey and the Family Expenditure Survey. However, there is no consolidated report on the tobacco market, and the data collected by HM Revenue and Customs are not fully utilised.
37. In particular the release of regular reports on the tobacco market detailing its structure, price variations within categories, calculated price-elasticities, consumption patterns by socio-economic group, age and other demographics, market share by brand and so on, would support the econometric work necessary to determine the impact of various different policy levers on smoking prevalence.

²⁰ Framework Convention on Tobacco Control. World Health Organization 2003. Article 6.

Counteracting misunderstandings about counterfeit products

38. We are concerned that HMRC is still putting across the false impression that counterfeit cigarettes are known to be more harmful than tobacco-manufacturer produced cigarettes. We raised this issue with your predecessor, John Healey, last year and he assured us that it had been taken on board.
39. However, since then HMRC has continued to put across the message that not only do counterfeit cigarettes potentially have higher levels of some toxins, but that they are also more deadly. For example, an HMRC press release in March 2007, subsequent to John Healey's assurance, stated that *"the startling truth is these unregulated cigarettes contain a seriously unhealthy mix of cancer-causing chemicals including arsenic, cadmium, benzene and formaldehyde. With expertly crafted packaging it is almost impossible to spot counterfeit cigarettes until you experience the ill effects from smoking them due to the highly toxic set of ingredients they contain"*²¹ and in a quote on the BBC's website dated 18 April 2007, John Kinghorn, HMRC's head of detection for the North, said, *"Counterfeit cigarettes are especially dangerous"*²².
40. To reiterate the key point, counterfeit cigarettes often contain higher levels of certain toxins such as heavy metals but this does not mean they are necessarily any more dangerous or will kill people any more quickly than genuine cigarettes. Tobacco industry manufactured, tax paid cigarettes also have significant levels of heavy metals such as cadmium, arsenic and lead, as well as thousands of other toxic substances and carcinogens and already kill half all lifelong smokers. Not enough is known about the impact of higher levels of heavy metals, the total toxic load of counterfeit cigarettes, or the relative importance of different toxins to be sure that they are even more dangerous than the legal product.
41. There is, however, a risk of unintended consequences that by implying that counterfeit cigarettes are more harmful that smokers could be reassured into thinking tobacco industry manufactured cigarettes are less harmful. This potentially undermines efforts to encourage them to quit, as was the case with low tar cigarettes.²³ The public health community is concerned about this risk and so also is the Department of Health.
42. We would therefore urge HMRC and HM Treasury to remove all references to increased health risk from counterfeit cigarettes from their publicly available materials and to ensure that no further references to increased health risk of counterfeit cigarettes is made by HM Treasury or HMRC and that if any such reference from the past is picked up by the media it is immediately corrected. It is justifiable to tell people that counterfeit cigarettes are shoddy, less well made and may contain all sorts of unwanted rubbish such as dust, bird droppings and insects. It is also justifiable to tell people that smuggled cigarettes are being sold by criminal gangs that may well have links not just with organised crime but also with terrorists. Research from the north-east of England shows that this information is of concern to smokers and will put them off buying illicit cigarettes.

²¹ HM Revenue & Customs (West Midlands) press release. *Hard hitting 'Counterfeit Kills' campaign highlights dangers of illicit cigarette trade* Wednesday 7 March 2007
<http://www.gnn.gov.uk/content/detail.asp?ReleaseID=269427&NewsAreaID=142&NavigatedFromSearch=True>

²² <http://news.bbc.co.uk/1/hi/england/humber/6567981.stm>

²³ Consumers and the Changing Cigarette. Health Education Authority, 1999

However, it is not accurate or sensible to imply that it will certainly be even more harmful to smokers' health than tobacco manufacturer produced cigarettes as this may have a counter-productive impact in leading smokers to believe that duty-paid cigarettes are less harmful.