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TOBACCO TAXATION

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KEY AREA PAPER : INDIRECT TAXATION OF TOBACCO PRODUCTS

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General Managers should refer to the Tobacco Taxation Guide (dated December 1994) for a general background and detail on indirect tax and trade issues. This Key Area Paper concentrates on the development of strategies to be adopted by operating companies.

A. THE ISSUE

Tobacco indirect taxation (excise tax, sales tax, VAT and import tariffs) is the most significant element of the retail selling price of tobacco products and hence plays a major role in determining the commercial environment in which we operate. In particular, indirect taxation determines the level of retail prices, the price structure and therefore the overall pattern of smoker demand for our products. It is also closely linked to, and significantly influences the level of profitability and cash flow performance of an operating company.

Excise taxation and VAT has always been a key issue, but is becoming even more so because of Government increases in the level, with resultant higher real prices, either for revenue or health reasons. Also, competition, particularly PM, increasingly seek to influence the structure of the taxation system in order to optimise their competitor position in the market place. The critical product category is cigarettes, which accounts for well over 90% of global tobacco consumption, this paper therefore focuses upon cigarettes, although there is some reference to other tobacco products.

International co-operation and cross fertilisation between Governments is increasing with regard to indirect taxation, as a result of which both taxation levels and structures are being shaped by external influences.

Tobacco indirect taxation is therefore an issue for General Managers who should advise Millbank of all changes in tax structures and levels, and discuss any proposals for change with Millbank prior to their submission to Government.

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B. POLICY

To manage the cigarette indirect taxation issue in order to establish the most appropriate retail price structure, whilst optimising profitability and cash flow over the long term.

C. STRATEGIES

This policy will be achieved by focusing upon the following main strategies :

1. To define the management responsibility for tobacco indirect taxation within your company both from the public affairs and commercial viewpoints.

2. To establish a structure or system of import duty and/or excise taxation most appropriate to the current and future BAT brand mix, securing maximum freedom to determine selling prices without Government intervention or approval, whilst also minimising the ability of the retail trade to vary prices from those recommended by, or fixed by the manufacturer.

3. To seek to reduce the incidence of indirect taxation, or to ensure that its level does not increase at a rate greater than inflation. To seek to ensure that the application of Value Added Tax to tobacco products does not increase the total tax burden.

4. To establish the most effective method of collecting the excise which :

    - maximises any excise credit terms.

    - maximises the involvement of the manufacturer in the collection of excise and minimises the involvement of the distributive and retail trades.

    - facilitates the establishment of firm retail prices.

    - minimises the ability of competitors to underpay their import duty and/or excise tax and so derive a competitor advantage.

5. To maintain a dialogue and close working relationship with key Government officials and Ministers and their advisors in order to influence their indirect taxation policy.

6. To lead, but act (where appropriate) with, the rest of the tobacco industry and to maximise the benefits from including other interested parties such as farmers, processors, suppliers and the trade.

These strategies are explained in greater detail in the subsequent sections.

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D. DEVELOPMENT OF STRATEGIES

1. Company Responsibility

Indirect tobacco taxation and pricing are general management issues and in addition will always involve different business functions within operating companies. It is essential to have clear responsibilities for the management of them.

The key elements are:

- strategic planning of excise tax systems and pricing
- accounting and computation of options
- management of payment and administration
- lobbying and Government relations

Millbank (Tobacco Taxation Department) is building expertise and contacts and a central database of information in order to assist operating companies. However, the responsibility of managing local excise issues is primarily that of the operating company and particularly the General Manager. Based on experience from around the Group and outside, lobbying arguments are being developed in Millbank and will be circulated to operating companies as appropriate. Operating company management should keep Millbank advised of developments on indirect tax matters and seek advice whenever necessary.

2. Structure of excise taxation and import tariffs

The structure of any excise system determines the pricing scenario of the market place and has a significant impact upon the level of profitability. Both Marketing and Finance should fully understand the implications of the current excise structure and establish whether a competitor advantage might accrue from a change to a different structure. In many instances, change may be either inappropriate or impossible while in other instances change may be appropriate and possible.

There is no single excise structure appropriate to BAT on a global basis because the competitor and brand mix situations vary widely. Companies should evaluate their own position and future plans in the market place, in order to determine the structure most appropriate for them. In most instances, long term profit optimisation will normally result from a totally or predominantly specific excise taxation structure, in preference to an ad valorem one. The optimum balance between specific and ad valorem will depend upon the brand mix of each company.

In a high inflation environment an advalorem structure is likely to be favoured by Government, otherwise the relative simplicity of a specific structure is appealing. Another significant decision influencing factor is the narrower price range in a specific environment. The structure is also highly relevant to the key issue of product quality with specific excise normally resulting in higher

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product quality than ad valorem because the latter encourages price competition and hence cost and quality reduction.

Import tariffs are still an important element in indirect taxation, but the trend internationally is rapidly moving towards a reduction of tariffs and other barriers to free trade. To rely on such tax barriers to 'protect' an uncompetitive business would not be viable in the longer term.

In the expanding global scenario whereby exports currently account for over 20% of BATCo cigarette sales, tariffs are an important indirect tax and commercial issue. Since most of our exports are of higher quality, higher price international brands, our policy in export markets is as follows:

- eliminate tariffs
- replace ad valorem tariffs with specific tariffs
- persuade Government to raise revenue through excise and other indirect taxation not tariffs
- lobby for specific or predominantly specific excise taxation, because ad valorem excise multiplies the amount of the tariff (a tax on a tax).

It should also be pointed out that our policy on tariffs in domestic markets is generally the opposite of the above. In markets where BAT has a dominant share, or where competition is limited because restricted access to the market keeps out imports, out policy is to persuade Government to minimise imports through the application of high tariffs and other obstacles such as pre-payment or early payment of excise taxes. (However, as noted above this is becoming more difficult.) Governments will be under increasing international pressure to equalise the excise.VAT structures and rates applicable to both imports and domestic productive Protection for domestic manufacture should therefore most appropriately be sought through a 'reasonable' import tariff.

The structure of taxation for products other than cigarettes generally follows one of the above options. In the main, cigars and cigarettes do not directly compete against each other with the possible exception of miniature cigars. Similarly, Pipe tobaccos, Chewing Tobaccos and Snuff do not compete directly against cigarettes. However Roll Your Own smoking tobacco is in direct competition with manufactured cigarettes. Companies must understand the relative excise incidence of these two product categories and their impact upon relative price levels and switching between the two categories. Although circumstances vary, the BAT policy is to minimise the price advantage of RYO and so maximise the market opportunities for manufactured cigarettes.

Government influence over retail prices varies from completely controlling them, to allowing full freedom to manufacturers. Retail prices vary from being fixed by law or practice to being free, with the manufacturers and the trade being able to change prices by whatever amount they wish, whenever they wish.

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Because circumstances vary widely, it is difficult to have a global strategy. However, the interests of the Group are best served by a situation where the company is free to determine the retail price for its brands which should then be fixed, with the trade margin being linked to this either as a fixed amount or a percentage (a fixed amount is preferable). Although it is normally difficult to dictate the degree of involvement of Government in the excise price process, one should seek to eliminate or minimise the involvement of the trade so that the balance of power stays with the manufacturers.

In markets where stick sales predominate, clearly the trade plays a key role, but companies should examine every opportunity to maximise the prices accruing to the manufacturer when excise increases are passed on to the consumer, although balancing this with the need to give the trade a satisfactory level of return based upon the actual stick price.

When permitted, it is normally preferable for the industry to apply for and implement price increases collectively and simultaneously and to negotiate with Government, where necessary, on an industry basis. The psychology of smoker demand is such that they are more likely to absorb smaller and more frequent price increases than larger and less frequent price increases. During negotiations with Government therefore it is preferable to seek the former excise environment. However, this has also to be interpreted in the context of the general level of inflation in the country plus the significance of stick sales and coinage availability which may act as a constraint to the implementation of this strategy.

In markets of high inflation, it is always preferable to take manufacturers prices increases ahead of inflation instead of behind it, with the exact timing sometimes determining the difference between operating profitability or a loss. The timing of manufacturer price increases however, sometimes has to be integrated with excise increases, and it is desirable that this should be so under certain circumstances, although flexibility not to do so should also exist.

It is frequently argued by the anti-smoking lobby that the price of tobacco products should be removed from the index of retail prices of the cost of living index. This would then enable Government to impose higher levels of excise for 'health' reasons, without impacting negatively upon the level of inflation. The effect of excise increases will be felt in any economy, whether or not they are included in an index of retail prices. To pretend otherwise is naive while to exclude a bona fide product from such an index would give rise to doubts about the validity of Government statistics generally. Such an action would limit the use of the index in economic policy formulation and economic planning generally because the use of an incorrect statistic will always have a distorting effect.

Companies should oppose any such attempt, and seek to enlist the support of trade unions who utilise the index for wage negotiations, together with economists and statisticians sympathetic to the position of the industry.

Although this is the general global strategy, there may be circumstances when the level of inflation combined with price controls may necessitate its removal if to do so is the only means of putting the industry on a basis of profitability, for example where a Government is refusing a necessary price increase because of its effect on the index of inflation. However, this should not be undertaken unless the positive results will accrue over the longer term.

In some countries, e.g. USA, Australia, Brazil, Canada, tobacco taxation is a mixture of Federal and Regional. This may offer opportunities to trade off one authority against another, either to achieve lower overall taxation or better tax credit payment terms. However, the relationships between the Federal and Regional authorities requires careful management since disharmony between the two authorities can equally lead to higher levels of taxation and worse credit terms.

3. **Level of Taxation**

The combined forces of Government revenue needs and the anti-smoking lobby have resulted in increased real levels of taxation in many countries, a situation which is likely to intensify further in the foreseeable future.

Every opportunity to reduce the level of taxation should be pursued even though the achievement of reductions may never be easy. If the taxable base can be expanded e.g. by including smoking products not presently taxed or which are evading tax, then Governments may be persuaded to effect rate reductions on cigarettes or not affect increases.

Should reductions prove to be unachievable companies should contain the increase in taxation to a level below the rate of inflation or at worst in line with it.

Arguments supporting this include:

- the inflationary and regressive impact of tax increases ahead of inflation, particularly upon lower income groups who frequently account for a disproportionately large amount of tobacco sales;

- the normal economic arguments that tax increases result in falling demand, employment, profitability and investment, both directly upon the company and indirectly upon suppliers;

- increases in taxation and hence retail price can result in the emergence or growth of transit or border trade business and hence a fall in revenue yield. This has very dramatically been illustrated recently in Canada. The high taxation policy followed by the Canadian Government, in an effort to reduce smoking incidence, has failed and the high levels of taxation have been reduced, smuggling has largely been overcome.

- high tax increases may result in smokers dropping out of the manufactured cigarette market and switching to RYO which is often taxed at a lower level or not at all. It is conceivable that overall Government receipts could fall in such circumstances;

- high taxation will incentivise evasion. It is essential to monitor competitor excise payment disciplines to ensure that we are not disadvantaged from either slower payment or non-payment by our competitors. Government should be advised of evasion by competition.

- increases in taxation which may result in a decline in consumption sufficient to bring about a fall in revenue yield to the Government. Because of the inelasticity of demand for cigarettes, over the longer term, this result rarely occurs. However, it is not uncommon to see a short term decline in revenue yield which can be pointed out to Government when opposing increases;

- increases in taxation which reduce consumption may mean the destruction of the vitality of the tobacco industry and thus the erosion of the tax base which Government may wish to protect over the long term. This applies even more in countries with a significant leaf export trade which depends to some extent upon the continued existence of the local industry.

- increases in taxation which are either out of line with international or regional norms or would result in the incidence of taxation becoming out of line with such norms.

It is BATCo policy that operating companies should not absorb indirect tax increases. These should always be passed on, unless there are very compelling reasons to the contrary.

Value Added Taxes (VAT) are always ad valorem. In many countries, where Governments are not confident of collecting all the VAT due from the wholesale or retail stages, manufacturers are required to charge the tax on wholesale or retail prices. This can be advantageous, it depends on the length of credit, there can be cash flow benefits and it gives manufacturers a greater degree of control over retail prices.

It is important, when VAT is applied to tobacco products, to seek to ensure:

a) that excise rates are reduced in compensation

b) that the tax regime allows the recovery of input VAT on all business purchases

c) that the length of credit adequately compensates for the costs of accounting for and collecting the tax for the Government.

d) that the collection of VAT does not extend beyond the manufacturing stage, unless controlled by the manufacturer as noted above.

4. **Excise Collection**

In all countries, the timing of excise payment is crucial because of its cash flow and profit implications. The minimum objective should be to ensure revenue neutrality whereby tax is not paid until payment has been received from the distributive trade However, one should always press for a period of tax credit which is positive, which covers one's costs of administering and collecting the tax on behalf of the Government, which covers any bad debts (if any) and which is consistent with the concept of all indirect taxation viz : that a consumption tax should be paid when the product is consumed, not when it is manufactured or still in the distribution pipeline. There have been occasions where Governments have increased the period of tax credit instead of permitting a price increase (the latter being inflationary) as a means of improving profitability.

Experience of indirect tax systems demonstrates clearly that it is preferable to minimise the involvement of the trade in the system so that the manufacturers essentially retain the optimum influence over the final retail selling price. In Europe in particular, the power and influence of the trade has and still continues to grow with resultant pressure upon manufacturers to give higher margins, bonuses or other incentive payments to the trade. One of the means whereby the influence of the trade has been contained is the existence of an excise collection system whereby only the manufacturers are involved, and where the trade margin is fixed either by law or practice on the basis of the price determined by the manufacturer in agreement with the Government. Attempts by the trade to be involved in collecting and paying over excise tax to the Government should be resisted strongly.

Where the excise is linked to the retail price of a brand, (normally via an ad valorem element) it is necessary to have either a fixed retail price for that brand or a recommended retail selling price or an agreed price for the purposes of calculating the excise. This is advisable also because it minimises the ability of the trade to reduce the retail price and so pass on to the consumer the multiplied effect of any price saving. To be able to vary the price upon which the excise is based and so vary the excise itself, would result in the trade effectively determining the retail price instead of the manufacturer doing so.

Although banderoles or fiscal markers are not desirable because of their negative impact upon manufacturing efficiencies, they may offer some scope for resolving the problem of smuggling or evasion.

5. **Relations with Government and its advisors**

Government officials responsible for tobacco excise and VAT planning and control, from a relatively low to the highest level, should be identified and sufficient regular contact maintained while Ministerial (Government & Opposition) contacts should also be maintained to ensure that the Company is well placed to have its views taken into consideration when policy is being determined. Such contact should be the responsibility of senior management and the Board to ensure an adequate level and quality of communication.

An amicable and effective partnership between company and Government is the objective. Rather than reacting to a problem, a positive and pro-active approach to this subject must be implemented. Such relations should establish BAT as the Company to which Government will turn when they need advice and assistance upon any aspect of excise taxation, which of course requires the existence of the knowledge and experience of excise in the Company. This is becoming more significant as our competitors seek to influence and change Government policy on excise structures from that which is appropriate to BAT to that which is more appropriate to their own brand mix. Conversely, we should examine the opportunities to change excise systems too, if indeed such a change would be beneficial. In either instance, good and regular Government relations are essential.

In this same context, it is also relevant to maintain close contact with manufacturers of products also subject to excise taxation, particularly alcohol, where there are many excise similarities and where a joint approach might have more impact. This is not an easy situation to bring about, but a good example of effective co-operation was the successful lobby campaign for the EU Duty Free extension.

Increasingly the influence of IMF and World Bank is being felt in the area of excise tax and VAT issues. Operating company management must be aware of their role and seek to influence decisions from these bodies e.g. most often ad valorem systems are proposed by IMF/World Bank, because of their belief, often misguided, that such systems are the most simple and maximise Government revenues. If this is not in our favour we must lobby against the proposals. IMF/World Bank policies are mostly directed from Washington DC and Millbank is establishing contacts there, in order to assist operating companies.

Operating company management should establish good working relationships with local representatives of IMF/World Bank/WTO organisations to ensure that our position and expertise on indirect tax and trade issues is appreciated. Whenever possible assistance and advice should be given. A good relationship will make any necessary local lobbying more effective. Assistance should be sought from Millbank (Tobacco Taxation Department) if a resolution of local issues could be expedited by the involvement of the international H.Q. of IMF/World Bank/WTO.

6. Industry Relations

In a competitive context, tobacco excise taxation is a key subject for discussion and agreement in the National Manufacturers Association. Collective action and influence by the industry is likely to be more effective and productive than by individual companies, although the latter may also be appropriate from time to time. Although the lead company on excise issues tends to select itself on the basis of market share, it can also be on the basis of knowledge, experience, contacts with Government. Where market share means that it is not BAT, companies should seek to ensure a lead position through these other means. Excise contains many complex aspects which have to be mastered if NMA leadership is to be established.

Although the main thrust on excise should and will always come from the manufacturers, some benefit may be derived from incorporating natural allies such as tobacco farmers, processors, suppliers to the industry, distributors and retailers in the lobbying activities of the NMA on excise levels.

Every opportunity for the industry to agree policy and act collectively should be taken. However, if agreement proves impossible, it will be necessary to devote the appropriate company resources to Government relations to ensure that the Group position and influence exceeds that of the competition.

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