

# Key Challenges in Tobacco Tax Administration – The Role of VAT

*Session 5: Challenges to advancing tobacco tax policies*

**Workshop: Advancing tobacco taxes in Latin America**

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29 October, 2024



# Initial considerations on the excise taxing point are needed to discuss tobacco tax administration

The excise taxing point should be set at the point of the tobacco supply chain that facilitates:

**Pass-through into retail prices**

Tobacco excise taxes have the greatest probability that they will be passed through into retail prices and reduce the affordability of tobacco products (to meet health and revenue objectives).

**Tax enforcement**

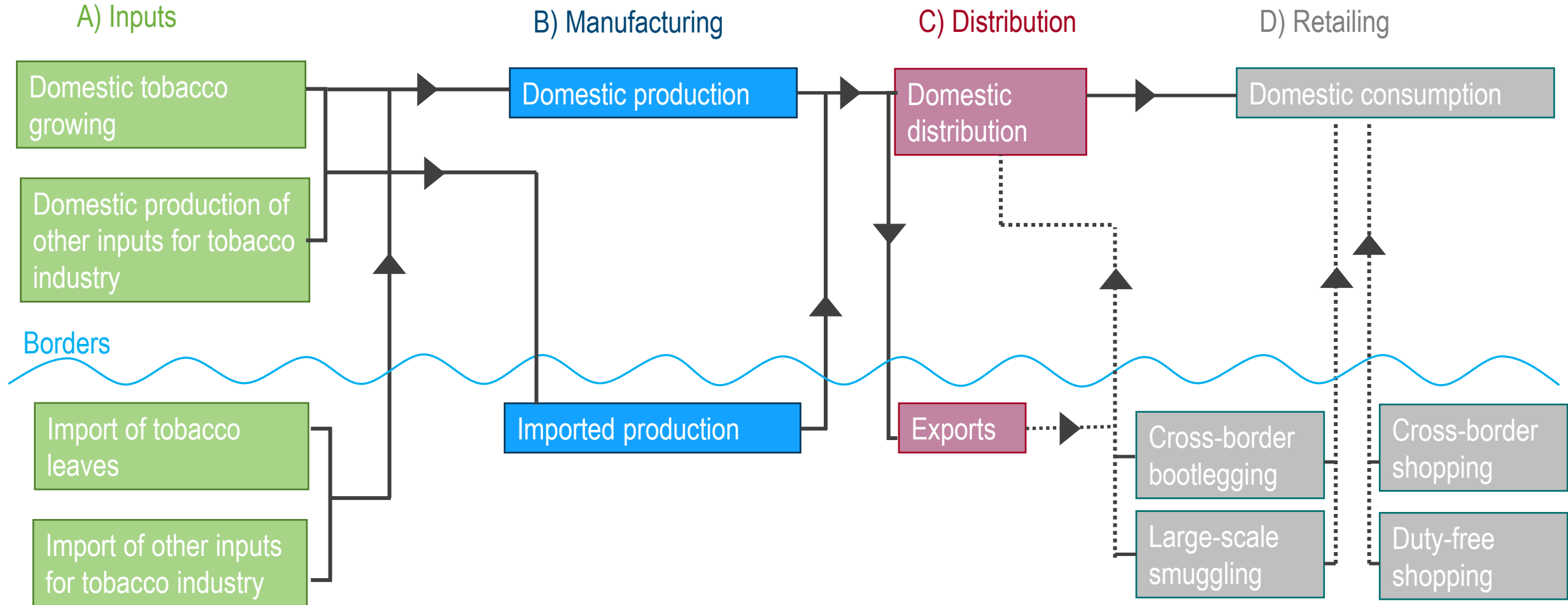
The tax administration can keep track of volume and the value of tobacco transactions and has to engage with a relatively limited number of agents (to ease the enforcement of the tax).

**Tax compliance**

Taxpayers have the resources and knowledge to comply with tobacco excise tax regulations (to ease voluntary compliance).



# The excise taxing point could be set at different stages of the tobacco value chain



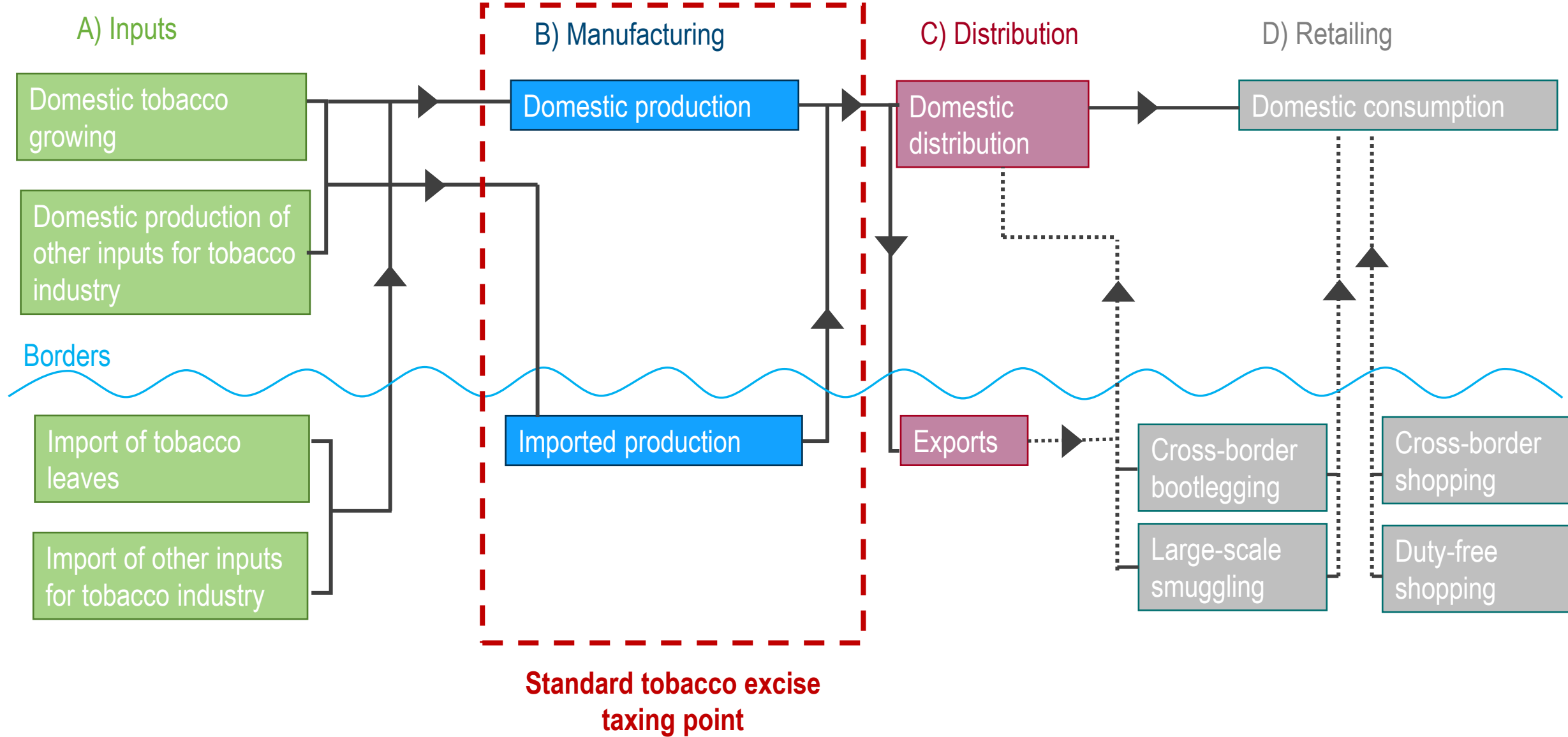


# Assessing tobacco excise taxing point options

	A) Inputs	B) Manufacture, imports	C) Distribution	D) Retailing
Pass-through into retail prices	<p>✗</p> <p>Early stage of the value chain</p>	<p>✗</p> <p>Intermediate stage of the value chain</p>	<p>✓</p> <p>Closer to retailing stage</p>	<p>✓</p> <p>Last stage of the value chain</p>
Tax enforcement	<p>✗</p> <p>Multiple entities involved</p>	<p>✓</p> <p>Usually reduced number of taxpayers</p>	<p>~</p> <p>Depends on market concentration</p>	<p>✗</p> <p>Multiple entities involved</p>
Tax compliance	<p>✗</p> <p>Low ability to comply</p>	<p>✓</p> <p>High ability to comply</p>	<p>~</p> <p>Depends on market concentration</p>	<p>✗</p> <p>If small retailers: low ability to comply</p>



# The standard tobacco excise taxing point is the manufacture and import of tobacco products





# Measures that help addressing the weaknesses of the standard tobacco excise taxing point (I)

	Weaknesses of the standard taxing point (manufacture/imports)	OECD recommendations
<p><b>Pass-through into retail prices</b></p>	<ul style="list-style-type: none"> <li>• <b>Narrow tax base</b> for ad-valorem structures, if it is set at the ex-factory or CIF values.</li> <li>• The tobacco product manufacturers are usually <b>highly profitable MNEs</b> which might have the ability to (partly) <b>absorb tobacco excise taxes</b>.</li> </ul>	<ul style="list-style-type: none"> <li>• With <b>ad-valorem structures</b>: introduce a <b>minimum tax</b> or price floor and levy the ad valorem excise tax on the <b>suggested or actual retail price</b> [BP17].</li> <li>• Consider the <b>tax administration capacities</b> of the country and align the tobacco <b>excise tax structure</b> with the excise <b>taxing point</b> [BP16]. <ul style="list-style-type: none"> <li>➤ <b>Preference for specific excise taxes</b>, particularly if tax administration capacities are low.</li> </ul> </li> <li>• <b>Monitor</b> pre-tax and retail <b>prices</b> over time and introduce <b>additional tax measures</b> if needed [BP13].</li> <li>• <b>Avoid</b> providing direct and indirect (tax and non-tax) <b>subsidies</b> to tobacco companies to prevent these subsidies from undermining the effectiveness of tobacco tax policies [BP19].</li> </ul>



# Measures that help addressing the weaknesses of the standard tobacco excise taxing point (II)

	Weaknesses of the standard taxing point (manufacture/imports)	OECD recommendations
<b>Tax compliance</b> <i>(taxpayer perspective)</i>	<ul style="list-style-type: none"><li>• Taxpayers are usually large companies with strong capacity to engage in <b>tax avoidance and evasion</b> behaviours.</li></ul>	<ul style="list-style-type: none"><li>• Introduce <b>measures to limit fraud and illicit trade</b> (i.e. modern fiscal markings; detailed tobacco transaction information in the tax returns; mandatory licensing) [BP15].</li><li>• Recurrent <b>monitoring of the tobacco market</b> and prices [BP13].</li><li>• Engage in <b>regional cooperation</b> on tobacco tax policy and <b>exchange</b> tobacco-related <b>information</b> [BP21].</li></ul>
<b>Tax enforcement</b> <i>(tax administration perspective)</i>	<ul style="list-style-type: none"><li>• <b>Customs</b> and <b>tax administration</b> might be <b>separate entities</b> with different regulations, responsibilities and <b>lack of coordination</b>.</li></ul>	<ul style="list-style-type: none"><li>• <b>Strengthen domestic tobacco tax cooperation</b>, including the tax administration and the customs authorities [BP20].</li></ul>



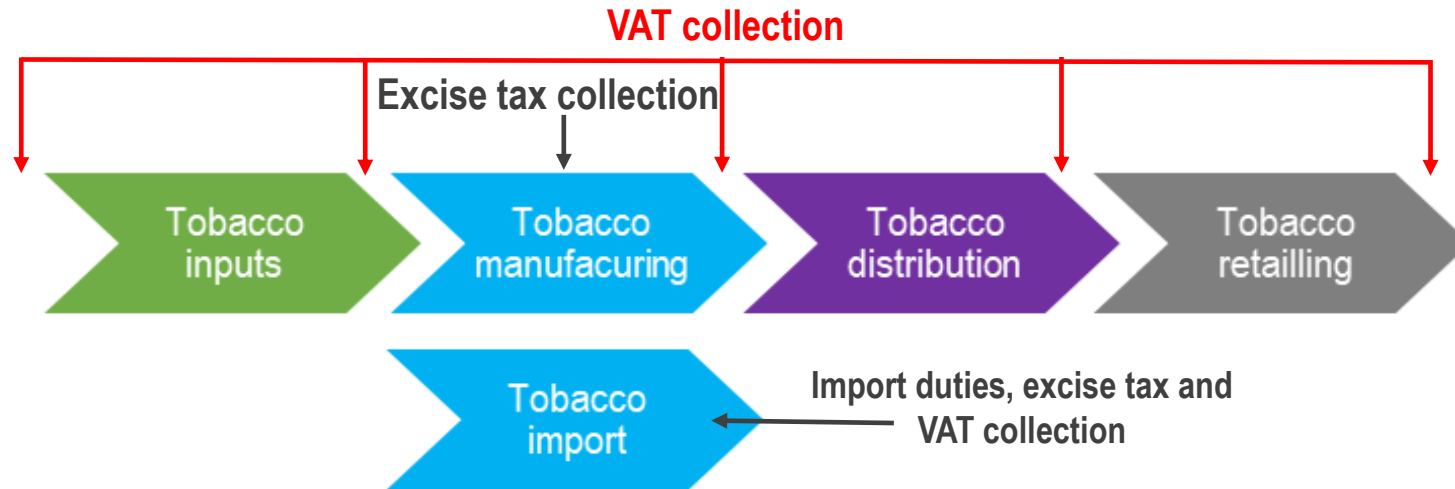
# The role of the VAT (I): Differences with excise taxes

	Excise taxes	VAT
<b>Taxable products</b>	> Selective list of products	> Most goods and services
<b>Number of taxpayers</b>	> Reduced	> Large
<b>Objective</b>	> Influencing business / consumer behaviours and revenue raising	> Revenue raising
<b>Structure</b>	> Volume-based (i.e. specific) or value-based (i.e. ad valorem)	> Value-based (i.e. ad valorem)
<b>Tax rates</b>	> Differentiated across products	> Uniform or with less differentiation
<b>Tax neutrality</b>	> No (single staged)	> Yes (multi-staged)





## The role of the VAT (II): Interactions with the tobacco excise tax



- > The different functioning of the tobacco excise tax and the VAT has **important implications**.
- > **Single-staged vs. multi-staged** taxes: the **excise tax represents a cost for the taxpayer**, while the VAT it does not, as the taxpayer can (usually) credit the VAT paid for their inputs. This is why the **VAT is tax neutral** for businesses.
- > If there is **pass-through**, the **excise tax** will be **included** as part of the tobacco product **price** in the next stages of the value chain.
- > When levied, the **excise tax** needs to be **included in the VAT tax base** to **avoid economic distortions** in the value chain. [Example in the next slide]



# The role of the VAT (III): Interactions with the tobacco excise tax – cont.

> Example: For the tobacco excise taxpayer (i.e. manufacturer)...

## the excise tax is excluded from the VAT tax base

### A. Different operators in the value chain:

- > Manufacturer sells to retailer at a price of 1000 + VAT  
Pre-tax price: 100; excise tax: 900; VAT (20%\*100): 20
- > Retailer sells to final consumer at a price of 1000 + VAT  
*[for illustrative purposes, retailer margin is 0]*  
Pre-tax price: 1000; VAT (20%\*1000): 200

→ Final retail price: 1200

→ Total taxes collected:  $900 + 20 + 200 - 20 = 1100$

manufacturer
retailer

### B. Single operator in the value chain (vertical integration)

- > Manufacturer sells to final consumer at a price of 1000 + VAT  
Pre-tax price: 100; excise tax: 900; VAT (20%\*100): 20

→ Final retail price: 1020

→ Total taxes collected:  $900 + 20 = 920$

## the excise tax is included in the VAT tax base

### A. Different operators in the value chain:

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Pre-tax price: 100; excise tax: 900; VAT (20%\*1000): 200
- > Retailer sells to final consumer at a price of 1000 + VAT  
*[for illustrative purposes, retailer margin is 0]*  
Pre-tax price: 1000; VAT (20%\*1000): 200

→ Final retail price: 1200

→ Total taxes collected:  $900 + 200 + 200 - 200 = 1100$

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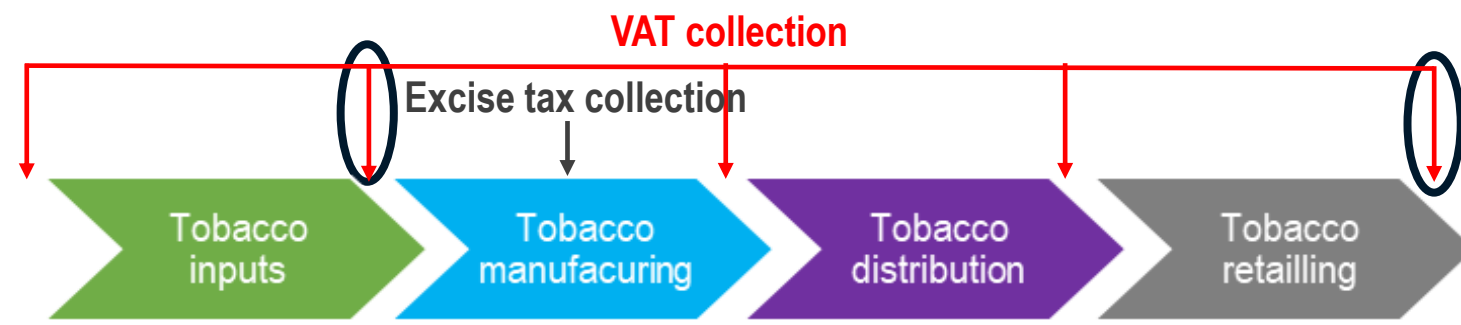


## The role of the VAT (IV): Interactions with the tobacco excise tax – cont.

- > **Excluding the excise tax** from the VAT tax base **incentivises vertical integration** of businesses.
  - > Vertical integration might also have **negative** consequences for the **excise tax pass-through**.
- > This issue could be alternatively avoided if:
  - > **Specific regulations** are foreseen to exclude the excise tax from the VAT base in all the stages of the value chain.  
**BUT:** adds **complexity** to the tax system, complicating tax compliance and enforcement.
  - > **Retail prices** of tobacco products are **set by the government** and are used to define the excise tax base (if ad-valorem) and the last-stage VAT base as well. **BUT:** this requires **strong market regulation**.
  - > The tobacco **excise tax** would be levied at the **last stage of the value chain** (i.e. by retailers). **BUT:** it would involve multiple **enforcement and compliance disadvantages**, as previously discussed.
- > Conclusion: **Levy the VAT on the tobacco excise tax-inclusive price** [BP18].
  - > This occurs in 13 out of 19 LAC countries.



# The role of the VAT (V): special treatments and implications for tobacco tax policy



- > **Tobacco cultivation** is often **exempt** from VAT or **zero-rated**.
  - > Zero rates do not affect the neutrality of the VAT (input VAT is recoverable).
  - > Exemptions affect the neutrality of the VAT as input VAT is not recoverable, hence it is a business cost.
    - Cascade effect: the unrecoverable VAT is translated into the price of tobacco products.
- > **Small retailers** of tobacco products might be **exempt** from the VAT if they fall below a VAT registration threshold or are allowed to register to simplified regimes that exempt **from standard VAT compliance** (e.g. Monotax regimes).
  - > VAT exemptions on retailers might create incentives for manufacturers to operate informally, undermining tobacco tax policy.
  - > These incentives can be intensified if several stages of the tobacco supply chain are VAT exempt.
- > From a **tax compliance perspective**, it is preferable that **all operators** involved in the tobacco supply chain are **liable to the VAT**.
  - > However, it is administratively costly to enforce the VAT to hard-to-tax individuals such as farmers or small retailers.



# The role of the VAT (VI): How can it help addressing tobacco tax administration challenges

## E-invoicing can easily address important challenges of the excise tax administration

- > **Tax administrations need information on prices of tobacco products to strengthen tobacco tax design and administration.** In particular:
  - > To levy the ad valorem excise tax on the retail price [BP17].
    - This price might not be available to excise taxpayers (manufacturers/importers)
  - > To monitor the tobacco market and prices over time and introduce additional tax measures if needed [BP13].
- > **Standard VAT returns** usually include **aggregated reported values** but lack information on volumes.
  - > Are not useful to track prices.
  - > However, they allow to track turnover and input values within the sector, providing a broad picture of the market.
  - > This information can also be compared with corporate income tax returns.
- > **E-invoices submitted to the tax administration** can easily provide retail prices of tobacco products.
  - > Small retailers might be exempt from e-invoicing, but large supermarkets should not.
  - > These prices can be used to define the ad-valorem excise tax base and to monitor the tobacco market on a regular basis.
  - > They can also be used to assess if indexed specific excise taxes follow the pace of pre-tax prices.

## The role of the VAT (VII): The way forward

- > In LAC, it is **still uncommon to levy the observed retail price** of tobacco products, although 12 countries have an ad-valorem excise tax for cigarettes (14 for other tobacco products). The few cases are:
  - > Brazil, Chile, and Colombia for cigarettes.
  - > Mexico for cigars, cigarillos and RYO.
- > It is still uncommon to rely on e-invoice information, despite **e-invoicing is common in LAC** (ISORA 2023).
- > **VAT and excise tax administration units** might be disconnected, **strong coordination** is needed.
- > A better understanding of **how excise taxes interact** with other indirect taxes and the overall tax system is **crucial** to ensure an **effective tobacco tax policy**.

# THANK YOU

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